

THE DEVELOPMENT OF FISCAL CONTROLS OVER INTERNATIONAL TRANSFER PRICING

by

HELOISE MARIKA BERTRAM

**A thesis submitted to the Faculty of Arts and Social Sciences
of The University of Birmingham
for the degree of
MASTER OF SCIENCE**

**Department of Accounting and Finance
School of Business
Faculty of Arts and Social Sciences
University of Birmingham
June 1999**

UNIVERSITY OF
BIRMINGHAM

University of Birmingham Research Archive

e-theses repository

This unpublished thesis/dissertation is copyright of the author and/or third parties. The intellectual property rights of the author or third parties in respect of this work are as defined by The Copyright Designs and Patents Act 1988 or as modified by any successor legislation.

Any use made of information contained in this thesis/dissertation must be in accordance with that legislation and must be properly acknowledged. Further distribution or reproduction in any format is prohibited without the permission of the copyright holder.

M0184078B4
21686343



ABSTRACT

Growth of multinational enterprises (MNEs) has resulted in rapid increases in the number of cross-border, inter-related transactions. Manipulation of the 'international transfer prices' (ITP) of these transactions enables MNEs to shift profits between jurisdictions and minimise global taxation.

In 1935, the US presented the arm's length principle (ALP), believing transactions between related companies should earn equally to identical transactions between independent companies.

Attempts, predominantly by the US and OECD, to control transfer pricing methods (TPMs) based on the now universally acknowledged, although increasingly inappropriate and outdated, ALP have resulted in the adoption of overwhelmingly prescriptive, increasingly demanding and punitive measures.

Advance pricing agreements (APAs) were introduced to resolve ITP disputes involving tax authorities and MNEs, offering opportunities to openly negotiate acceptable TPMs in advance. APAs in their current form, however, are complex, time-consuming and demand sensitive information disclosure. APAs appeal to MNEs suffering only the most costly ITP disputes.

A major concern for MNEs with operations in different tax jurisdictions is double taxation. This is alleviated firstly, through the harmonisation of world-wide adopted US regulations

and OECD guidelines; secondly, the maintenance and expansion of treaty networks, facilitating inter-governmental communication on MNEs; and finally, the introduction of 'last resort' arbitration services.

TABLE OF CONTENTS

CHAPTER	TITLE/SECTION	PAGE
1	INTRODUCTION TO INTERNATIONAL TRANSFER PRICING	1
2	ARM'S LENGTH PRINCIPLE	22
3	PROFIT-BASED TRANSFER PRICING METHODS	38
4	GROWTH OF INTANGIBLE PROPERTY	57
5	TRANSFER PRICING HARMONISATION	73
6	A TIMELINE OF TRANSFER PRICING LEGISLATION	103
7	MODERNISATION OF THE UK TRANSFER PRICING LEGISLATION	119
8	ADVANCE PRICING AGREEMENTS	145
9	DOUBLE TAXATION RELIEF	186
10	CONCLUSION	205
	APPENDICES	217
	GLOSSARY	236
	BIBLIOGRAPHY	248

TABLE OF CONTENTS

CHAPTER	TITLE/SECTION	PAGE
1	INTRODUCTION TO INTERNATIONAL TRANSFER PRICING	1
	Growing Importance of Transfer Pricing	2
	Firms Multiple Motivations in Transfer Pricing	4
	- Market-Based Versus Non-Market Based Methods	4
	- Objectives of MNEs Setting Transfer Prices	5
	- Do Objectives Change Over Time	8
	- Contradicting Objectives	9
	- How Can MNEs Achieve Their Objectives	10
	- The Transfer Pricing Method (TPM) Preference of American and Japanese MNEs	10
	- Legal and Size Factors Affecting the Choice of TPM	12
	- Transfer Pricing in the Decision-Making Framework	14
	- Nationality Affects the Importance of Transfer Pricing in Strategic Decision Making	15
	- Transfer Pricing for Management Purposes	16
	- Financial Outcomes of Setting Transfer Prices	16
	- Overview of Empirical Literature	17
	Ability of Tax Authorities to Collect Their "Fair" Share of Tax	18
	- Legal Restraints	19
	- The Power of Stricter Jurisdictions	19
	Following Chapters	21
	Research Methods	22
2	ARM'S LENGTH PRINCIPLE (ALP)	24
	- Guidance Applying ALP	27
	Traditional Transaction Methods	28
	- Comparable Uncontrolled Price (CUP) Method	28
	- Resale Price Method	30
	- Cost Plus Method	32
	Complying with the Methods	33
	Global Formulary Apportionment (GFA)	34
	ALP as the "Best Option"	36

3	PROFIT-BASED TRANSFER PRICING METHODS	38
	Profit Split Method	39
	<ul style="list-style-type: none"> - Division of Profits 	40
	<ul style="list-style-type: none"> - Functional Analysis 	40
	<ul style="list-style-type: none"> - Use of Profit Split Method 	41
	<ul style="list-style-type: none"> - Japanese Profit Split Method 	43
	<ul style="list-style-type: none"> - US Versus OECD Profit Split Methods 	43
	Comparable Profit Method (CPM)	44
	<ul style="list-style-type: none"> - Acceptable Range 	45
	<ul style="list-style-type: none"> - Advantages and Disadvantages 	46
	<ul style="list-style-type: none"> - Not An Arm's Length Method 	47
	<ul style="list-style-type: none"> - US Introduction of CPM 	50
	<ul style="list-style-type: none"> - Change in Emphasis on US Side 	51
	<ul style="list-style-type: none"> - Change in Emphasis on OECD/European Side 	51
	<ul style="list-style-type: none"> - CPM Conclusion 	52
	<ul style="list-style-type: none"> - TNMM Similar to CPM? 	53
	TNMM	53
	<ul style="list-style-type: none"> - Arm's Length Range 	55
	<ul style="list-style-type: none"> - CPM and TNMM Compared 	55
	Conclusion	56
4	GROWTH OF INTANGIBLE PROPERTY	57
	<ul style="list-style-type: none"> - Intangibles Defined 	59
	<ul style="list-style-type: none"> - OECD and Intangibles 	59
	<ul style="list-style-type: none"> - Problem of Measuring Intangible Property 	61
	<ul style="list-style-type: none"> - The US and Intangible Property 	62
	<ul style="list-style-type: none"> - 1968 Cost-Sharing Provisions 	63
	<ul style="list-style-type: none"> - "Commensurate With Income" Standard 	64
	<ul style="list-style-type: none"> - 1992 US Proposed Regulations 	66
	<ul style="list-style-type: none"> - 1993 Temporary Regulations 	66
	<ul style="list-style-type: none"> - Developments Since 1993 	68
	<ul style="list-style-type: none"> - Japan, Germany and The Netherlands 	68
	<ul style="list-style-type: none"> - Japan 	69
	<ul style="list-style-type: none"> - Germany 	69
	<ul style="list-style-type: none"> - The Netherlands 	70
	<ul style="list-style-type: none"> - Country Conflicts 	70
	<ul style="list-style-type: none"> - Hindsight Adjustments 	71
	<ul style="list-style-type: none"> - Special Considerations for Intragroup Services 	71
	<ul style="list-style-type: none"> - Need More Research 	72
	<ul style="list-style-type: none"> - Conclusion 	72

5	TRANSFER PRICING HARMONISATION CPM and the "Commensurate With Income" Standard 1992 OECD Task Force Best Method Rule Change in the View of CPM Non-Arm's Length Methods Comparability <ul style="list-style-type: none">- Functional Analysis- Contractual Terms- Economic Circumstances- Business Strategies Arm's Length Range Multiple Year Data Periodic Adjustments Penalties and Documentation <ul style="list-style-type: none">- Documentation- Transfer Pricing Penalties- Avoidance of Transfer Pricing Penalties Further Harmonisation? Progress Since OECD 1995 Guidelines Conclusion	73 74 77 78 80 82 84 84 84 85 85 88 90 90 91 91 93 96 99 99 102
6	A TIMELINE OF TRANSFER PRICING LEGISLATION Pre-Sixties <ul style="list-style-type: none">- 1921- 1928, 1932, 1935, 1954, 1957 Sixties <ul style="list-style-type: none">- 1962, 1964, 1968 Seventies <ul style="list-style-type: none">- 1970, 1975, 1976- 1977, 1979 Eighties <ul style="list-style-type: none">- 1982- 1983, 1984- 1986, 1987- 1988 Nineties <ul style="list-style-type: none">- 1990, 1991, 1992- 1993- 1994- 1995, 1996- 1997	103 104 104 105 106 106 107 107 108 108 108 109 110 111 111 112 113 114 115 116

7	MODERNISATION OF THE UK TRANSFER PRICING LEGISLATION	119
	Current UK Legislation	120
	Proposed UK Legislation	122
	The Basic Pricing Rule	124
	One-Way Street	125
	Secondary Adjustments	126
	Scope of the Legislation	128
	- Definition of Control	128
	- Joint Ventures	129
	Financial Transactions and Arrangements	130
	Foreign Exchange and Financial Instruments	132
	Commencement	134
	Central Monitoring of Transfer Pricing Enquiries	135
	Compliance Costs	137
	Return Requirement	138
	Documentation Requirements	139
	Penalties	143
	Conclusion	144
8	ADVANCE PRICING AGREEMENTS (APA)	145
	Birth of the American Programme	146
	Uni-, Bi and Multilateral Agreements	148
	- Unilateral Agreements	149
	- Bilateral and Multilateral Agreements	149
	- Competent Authority	150
	Advantages of APAs	152
	- Certainty of Treatment and Protection from Penalties	152
	- Protection from Double Taxation	152
	- Application to Other Jurisdictions	153
	- Review in Non-Confrontational Environment	153
	- Present Cases	153
	- Record Keeping Burden	154
	- Maturing of US Programme	154
	Disadvantages of APAs	155
	- Information Disclosure	155
	- Complexity and Length of Time to Complete an APA	156
	- Cost to Taxpayers and Revenue Authorities	157
	- Breadth of APAs	158
	- Cancellation of an APA	158
	- French and German Views	158
	- Concluding Remarks	159
	US APA System	159
	- Considerations before Application	159

CHAPTER	TITLE/SECTION	PAGE
8	ADVANCE PRICING AGREEMENTS (CONTINUED) <ul style="list-style-type: none"> - Pre-filing Conference 161 - Apportionment Methodology 162 - General Factual and Legal Items for Proposed TPMs 163 - Specific Factual Items for a Proposed TPM Other Than a Cost Sharing Arrangement 164 - Specific Factual Items for a Cost Sharing Arrangement 165 - Critical Assumptions 167 - Annual Reports 167 - Term and Timing 168 - User Fee 168 - Processing of APA Requests 169 - Concluding an APA 170 - Revocation and Cancellation of an APA 170 - Growth and Maturity of the Programme 171 Different Countries Experiences with APAs 174 <ul style="list-style-type: none"> - Australia 174 - Canada 174 - China 176 - France 177 - Germany 177 - Italy 178 - Japan 178 - Korea 179 - Mexico 180 - Netherlands 180 - Spain 181 - Sweden 181 - Switzerland 182 - UK 182 Conclusions 185 	
9	DOUBLE TAXATION RELIEF 186 <ul style="list-style-type: none"> - Territoriality and Residency 187 - Effect on International Trade 188 Unilateral Relief 189 <ul style="list-style-type: none"> - Foreign Tax Credit 189 - Treat Tax as a Business Expense 191 - Exemption Method 191 Double Taxation Treaties 191 <ul style="list-style-type: none"> - Model Tax Treaties 192 - Competent Authority Procedure 193 - US Revenue Procedure 96-13 195 	

	<ul style="list-style-type: none"> - US Revenue Procedure 96-14 - Problem of Not Reaching a Conclusion - Timely and Expensive - Updating and Negotiation of Treaties - Changing Treaties - UK Treaty Relief - Exchange of Information 	196 196 198 200 201 201 201
	Arbitration Convention	202
	Conclusion	204
	CONCLUSION	205
	APPENDICES	217
	1. Estimates of the Value of Transfer Pricing Transactions	218
	2. Differences in Importance of Variables in Transfer Pricing Determination	219
	3. Profit Split Method Definition From 1993 US Temporary Regulations	220
	4. CPM Definition Taken From 1993 US Temporary Regulations	221
	5. UK 1970 Taxes Management Act - Section 30C	223
	6. UK Transfer Pricing Documentation Requirement	226
	7. Questions on the UK Use of Advance Pricing Agreements	232
	8. Article 9 of OECD Model Tax Treaty	234
	GLOSSARY	236
	BIBLIOGRAPHY	248

LIST OF TABLES

CHAPTER	TABLE NUMBER	TITLE	PAGE
1	1.1	Environmental Variables of International Transfer Pricing	7
	1.2	Transfer Pricing in the Decision Making Framework	15
3	3.1	Percentage of Methods Used For All Types of Transactions	48
	3.2	Percentage of Methods Used By Type of Transaction	49
4	4.1	US Firms’ International Receipts and Payments of Royalties and License Fees, 1960-90	58
8	8.1	US APA User Fees	169

CHAPTER 1.

INTRODUCTION TO INTERNATIONAL TRANSFER PRICING

INTRODUCTION TO INTERNATIONAL TRANSFER PRICING

Growing Importance of Transfer Pricing

This study begins by asking the most basic and most easily answered question of all: Why have companies spread their operations from a domestic to a multinational level. This change has led to a large number of problems with transfer pricing and a lot of attention from governments and companies.

Arpan (1988) listed a number of reasons, most of which are obvious, to explain multinational growth. Firstly, raw materials not available or in short supply for one multinational enterprise (MNE) unit in one country can be imported for sale or further processing by another unit located in a different country. Secondly, some stages of an MNE's production process can be orchestrated more efficiently away from the headquarters, for example assembly plants for automobiles are established in lower labour-cost countries. Thirdly, the option of MNEs to operate sales and distribution offices in countries and importing goods from manufacturing affiliates located in other countries. Fourthly, many services for MNE units are rendered by the head office or an affiliate which benefit all, such as an advertising campaign. Finally, there are many international financial flows between units of an MNE. Some are payments related to goods and services provided by other units; loans or loan repayments; dividends; and some are designed to lessen taxes or financial risks.

MNEs are now major players in the global economy. The phenomenal growth of a number of businesses is demonstrated by the findings of Benson and Lloyd (1983), who noted that of the 100 largest economic units in the world, only half are nation states, the rest being transnational corporations. Additionally, the 1997 Ernst and Young Report (1997a) points out that many multinational companies currently generate as much, or more, taxable income outside (as within) their home jurisdiction.

Through the global growth of business, transfer pricing has evolved significantly from its origins as a local tax matter (Ernst and Young, 1997a). Elliott (1995b) noted the findings of the Ruding Committee which estimated the value of transfer pricing transactions, in 1992, involving EC countries as based on 1989 data (Appendix 1). This value although very sizeable is much greater today, as Kim, Swinnerton and Ulferts (1997) noted: "It is hard to grasp how the global economy has changed since 1990."

Transfer pricing effects nearly every aspect of multinational operations - research and design, development, manufacturing, marketing, distribution, after-sales services and most critically, an organisation's world-wide tax burden (Ernst and Young, 1997a). It is the last aspect that is of particular interest to government fiscal authorities. In 1992, President Clinton cited that the US federal government was losing at least \$10-12 billion in tax revenues annually (Bucks and Mazerov, 1993). The heightening awareness of the potential scale of losses is a reflection of the keen requirement of governments to ensure they are receiving their fair share of tax dollars (Humphreys, 1994).

The increase in attention from governments, in the form of (more) prescriptive legislation and increased auditing, has effected MNE's such that 81% of the firms that Ernst and Young (1997a) approached said that transfer pricing had become the most important tax issue. This can be compared to the 1995 report (Ernst and Young, 1996) which recorded that 82% of firms thought transfer pricing a 'key issue' as opposed to being 'the most important concern'.

Firms Multiple Motivations in Transfer Pricing

Elliott (1995) explained that a firm may use cost-orientated transfer prices (internal costs) or a system based on market prices (external prices). Which method is preferred depends on the objectives of an MNE. Elliott (1995) noted, for example, that some jurisdictions thought transfer pricing a gambit employed by MNEs to minimise global taxes. The belief that this is really the case may be a main reasons that governments prefer that transfer prices be set according to market prices, the prices of independent competitors. However, Thomas (1971) pointed out, this may not be the optimum pricing method since transfer prices based on market prices reflect true value only when they are determined in a freely competitive market (Arpan, 1988). Markets are unlikely to be freely competitive by the very nature of the multinationals operating in them (the characteristics are more likely to be monopolistic).

- Market-Based Versus Non-Market Based Methods

According to Arpan (1988) companies prefer cost-based prices because of the greater flexibility which they offer compared to market-based prices. Any cost element that enters

into the computation of the base transfer price can be changed as well as the percentage mark-up, it is more difficult to change a transfer price based on market prices.

- Objectives of MNEs Setting Transfer Prices?

There are a number of restraints affecting an MNE achieving their objectives. Plasschaert (1979) suggested the following inducements for transfer pricing manoeuvres:

- Restrictions on ownership: actual nationalisation or threats of expropriation, with or without 'adequate' compensation, or the obligation to enter into joint ventures with local private or public sector interests.
- Taxes on corporate profits.
- Import duties
- Exchange controls, such as restrictions on profit remittance or dual exchange rates.

In addition, it is also useful for directors to be able to take out their fees in low tax areas (Kirsch and Johnson, 1991).

Ernst and Young's 1997 Transfer Pricing Report (1997a) looks at the factors considered in shaping the transfer pricing policies of MNEs. The study found that maximising operating performance came as a top priority for firms. Optimising tax arrangements, documentation in preparation for audit and financial efficiencies, which were all, considered important but not a main priority followed this. Finally, performance incentives were established as of low importance. Were companies saying that tax minimisation was not their main priority simply to reassure authorities or because it genuinely was not? If this were the case, would their shareholders be as unconcerned with their loss of income.

Leitch and Barrett (1992) made a valuable comment on tax minimisation as an important objective and noted that: "It is only one of the many components that follow from ownership, location, and internationalisation advantages that arise from market imperfections. These other components, such as low labour rates, may indeed be much more important to profit maximisation."

It is very difficult to prove that tax avoidance is the top transfer pricing objective. According to Outram (1996): "Hard figures about the cost of corporate tax avoidance are hard to come by (although it is widely accepted that international tax planning denies the British Treasury billions of pounds every year)."

Tang (1992) received information from 98 companies and carried out a similar study by "judging the importance of twenty environmental variables that multinational firms usually consider when formulating their international transfer pricing (ITP) policies". The results were as follows:

Table 1.1

Ranking of Average Importance		
1990	1977	Variables
1	1	Overall profit to the company.
2	4	Differences in income tax rates and income tax legislation among countries.
3	2	Restrictions imposed by foreign countries on repatriation of profits or dividends.
4	3	The competitive position of subsidiaries in foreign countries.
5	6	Rate of customs duties and customs legislation where the company has operations.
6,7,8	8	Restrictions imposed by foreign countries on the amount of royalty or management fees that can be charged against foreign subsidiaries.
6,7,8	11	Maintaining good relationships with host governments.
6,7,8	9	The need to maintain adequate cash flows in foreign subsidiaries.
9	7	Import restrictions imposed by foreign companies.
10	5	Performance evaluation of foreign subsidiaries.
11	16	The need of subsidiaries in foreign countries to seek local funds.
12	12	Devaluation and revaluation in countries where the company has operations.
13,14	15	Anti dumping legislation of foreign countries.
13,14	20	Anti-trust legislation of foreign countries.
15	17	The interests of local partners in foreign subsidiaries.
16	10	Rules and requirements of financial reporting for subsidiaries.
17	14	Volume of inter-divisional transfers.
18	13	Rates of inflation in foreign countries.
19	19	Risk of expropriation in foreign countries where the company has operations.

20	18	US government requirements on direct foreign investments.
----	----	---

Environmental Variables of International Transfer Pricing

'Overall net profit to the company' appeared the most important factor in both years. This was followed shortly by 'differentials in income tax rates and income tax legislation among countries,' 'restrictions of repatriation of profits or dividends,' 'the competitive position of foreign subsidiaries,' and 'rate of customs duties and customs legislation where the company has operations'.

In comparison, in 1979, two years after the initial ranking year, Wu and Sharp (1979) found that the main criteria affecting the method choice were compliance with tax and tariff regulations and MNE profit maximisation (Borkowski, 1990).

- Do Objectives Change Over Time?

The following three variables progressed up the above table markedly during the period: the maintenance of a good relationship with host governments'; 'the need for subsidiaries in foreign countries to seek local funds'; and finally, 'the effect of anti-trust legislation of foreign countries'.

The table also recorded a drop of three criteria over the period. They are 'the performance evaluation of foreign subsidiaries', 'rules and requirements of financial reporting of foreign subsidiaries' and finally 'the rate of inflation in foreign countries'.

Comparing this table to Arpan's (1972) findings (Appendix 2) it can be seen that there is some alteration in the importance of variables over time. Arpan recorded that the American, Canadian, French and Italian companies considered income taxes to be the most important variable and the British considered the improvement of financial appearance of US subsidiaries most important.

- Contradicting Objectives

Plasschaert (1979) warned that these transfer pricing motivations can conflict, possibly causing more harm than good; for example, under-pricing of exports by a parent company may lead to a fall in corporate taxes paid in one country, however, this advantage may be offset by higher import duties. Another reason for the under-pricing of exports by the parent company is in order to extract profits and capital out of a country, with a weak currency or with an unfavourable investment climate which is likely to entail higher import duties in the host country.

Leitch and Barrett (1992) noted contradicting internal and global profit-maximising objectives. They found that since an MNE might aim to maximise the profits of their division so it would affect the MNE group's profit-maximising potential. For example, an MNE group would want an MNE in a high tax country to transfer as much profit out of the country and hence as low a profit level as possible.

In addition, Plasschaert (1979), offered a number of other limiting factors preventing the maintenance of an optimal transfer pricing system. The first was the administrative cost of handling a successful programme, particularly with a diverse assortment of goods and

services with production facilities spread worldwide. Governments would be suspicious if a company with such operations were constantly changing export prices, but on the other hand a transfer pricing system would require frequent updating to keep au courant with world-wide modifications to corporate tax rates, import duties and a number of other factors. Such manoeuvring would inevitably affect the profits of subsidiaries, possibly negatively, and this could lead to resentment and protests that could invite legislative interest and investigation.

Plasschaert (1979) noted that transfer pricing policies need "central monitoring", planning and decision making, yet this often conflicts with the 'profit-centre' philosophy which calls for decentralised decision making authority and, where product mix allows, for freedom to procure inputs from unrelated suppliers. Finally, firms usually plan long-run target rates of return and fix prices or alternatively follow the 'price-leader' in the field, and hence there may be little "room for deliberate tax- or regulation-minimising fiddling with transfer pricing" (Plasschaert, 1979).

- How Can MNEs Achieve Their Objectives?

Shulman (1969) noted that companies could achieve lower taxes by circumventing profit repatriation restrictions by charging a higher price for imports between related companies. Similarly, lower prices could be charged to avoid high import duties in host countries (Al-Eryani et al, 1990).

- The Transfer Pricing Method (TPM) Preference of American and Japanese MNEs

In 1997, Borkowski (1997) attempted to determine whether organisational, environmental or financial factors most affected transfer pricing choices of US MNEs with subsidiaries in Japan and Japanese MNEs with subsidiaries in the US. The findings were as follows:

1. 82% of Japanese MNEs favoured non-cost methods, a reflection of the cultural emphasis on long-run performance and collectivism to achieve best results. 42% of US MNEs preferred cost and 53% preferred non-cost methods.
2. Performance evaluation was found to be more important to the Japanese in deciding transfer pricing. Segmental profit is more significant to non-cost MNEs (which are mostly Japanese-owned). Size was also important since non-cost MNEs were generally much larger organisations.
3. US firms were more likely to be audited and this is partly reflected in their preference for cost-based transfer pricing methods.
4. US firms reported better financial results, possibly due to their optimistic approach, a difference in accounting and reporting principles or because they genuinely are more successful.
5. If free from constraints, both US and Japanese MNEs would switch from cost-based methods to the comparable profit method and the resale price method.

Borkowski (1997) suggested that methods were chosen in response to legislation rather than just to maximise operations.

Japanese-owned companies were also used for a study by Cravens and Shearon (1997) to illustrate how political-based factors effect the use of transfer prices. They noted that Japanese MNEs trust their own government's actions (over foreign governments) and prefer to shift profits to Japan regardless of whether the tax rates are lower because of the greater certainty and predictability. Additionally, Cravens and Shearon (1997) posited that firms are encouraged to set transfer pricing to increase their global competition, which is aided by the ability to carry out global sourcing.

- Legal and Size Factors Affecting the Choice of TPM

Borkowski (1990) and Al-Eryani et al (1990) investigated the effects of environmental variables on the determination of ITP strategies by US MNEs. The latter study concentrated on US-based firms and the former looked more specifically at US-based manufacturing firms. "The significance of the legal and size priorities rather than other factors in determining the choice of a market-based transfer pricing strategy suggests that legal rather than economic or social constraints play an important role in selection of transfer pricing strategies" (Al-Eryani et al, 1990).

In 1992, Borkowski carried out two further studies. One study investigated the differences between domestic and international transfers and the other study involved organisational and international determinants affecting the TPM (Cravens and Shearon, 1997). The second study found that "tax and tariff concerns, the stability of the parent MNE's economy, the ease and

cost of implementation, the use of subsidiary profits for performance evaluation, and the degree of the MNE's decentralisation all contribute to the choice of method" (Borkowski, 1992).

Yunker (1982) identified overall market conditions and demand for the product, government regulations and restrictions, and economic conditions as motivating criteria affecting the TPM chosen.

Benvignati (1985) carried out a study comparing TPMs and company characteristics and commented on the preference of large firms, and those with a large number of subsidiaries. He found that the MNEs mostly used market-based methods on the grounds that their size encouraged attention from local authorities so they felt constrained to follow the most acceptable methods.

Avoiding expensive conflicts with local regulatory authorities, Arpan (1979) has the same view as Benvignati (1985) that larger firms choose to use the more acceptable methods. Arpan (1979) noted that non-US MNEs mostly used market pricing to price inter-company transfers. Tang (1979) added to these findings that the cost-plus method was most popular amongst both US-owned and Japanese-owned companies. Al-Eryani et al (1990) wrote that most of the firms they investigated used a combination of market and non-market based transfer prices as a basis and found that those methods ultimately chosen closely abided by the US tax regulations. This is an opinion also expressed by Borkowski (1997). Arpan (1979) concluded that there is no universally optimal system of international intra-corporate pricing (Al-Eryani et al, 1990).

The reluctance to use non-market based methods is explained by Lecraw (1985) who noted that MNEs methodically used these procedures to reduce custom duties and taxes, and to circumvent government prices and capital-profit remittance controls. Furthermore, Plasschaert (1985) found this more widely spread in Less Developed Countries because of their inability to interpret or oversee the convolution of ITP.

Cravens and Shearon (1997) criticised the above reports saying that only legal and size variables have any real significance in predicting the method. They noted that: "The objective of transfer pricing relates to an outcome rather than the means by which the objective is achieved, the transfer pricing method."

Cravens and Shearon (1997) agreed with Plasschaert (1979) and found that, with the multifarious inducements to 'practice transfer pricing gambits', MNE's are actually indifferent to the actual method, so long as it provides the easiest way of flowing funds in and out of the desired countries.

- Transfer Pricing in the Decision-Making Framework

The Ernst and Young 1997 Report looked away from the methods, to examine the positioning in the organisation of transfer pricing decision making. They explained that since transfer pricing affects so many different aspects of an MNE's business (research and design, performance evaluation and so on), decisions made in these areas have an impact on the ability of the MNE to withstand attack from fiscal authorities around the world. The chart below demonstrates a conflict over the residence of transfer pricing in the organisation.

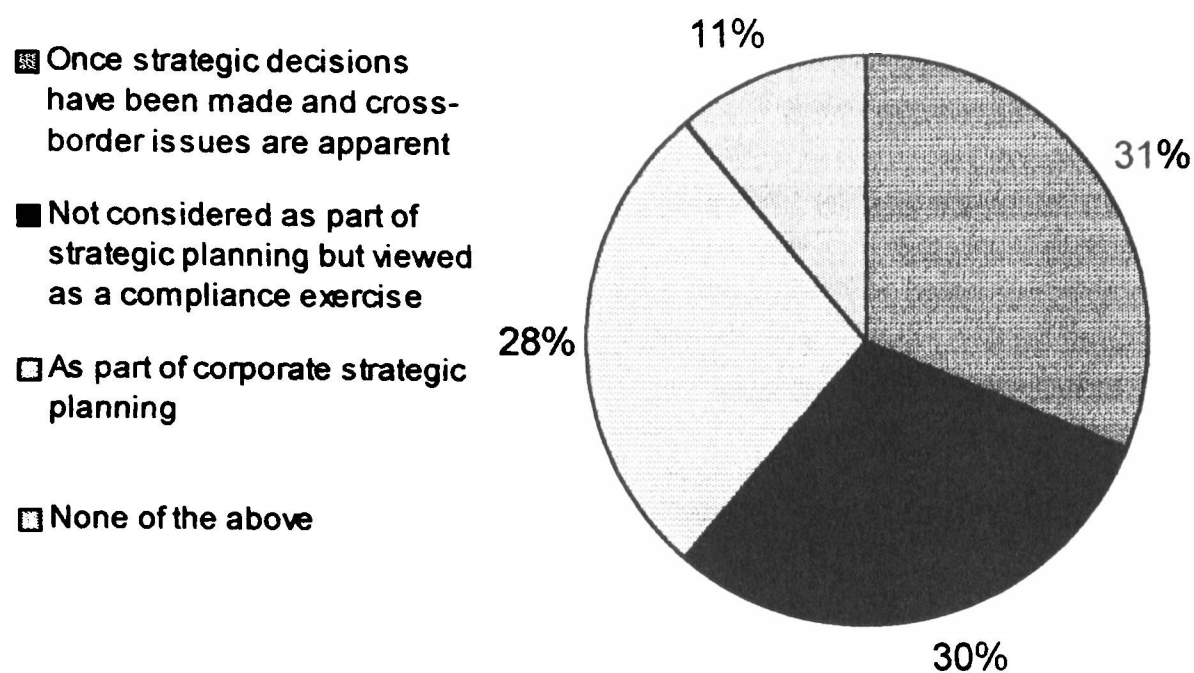


Table 1.2

Transfer Pricing in the Decision Making Framework

"The Tax function is too often left to cope with decisions to which it has provided little or no input. This reflects a commonly held view that taxes are merely a cost of doing business."

Ernst and Young (1997)

- Nationality Affects the Importance of Transfer Pricing in Strategic Decision Making

There is a country-by-country determinant not illustrated in the above diagram. For example, 48% of German and Swiss owned MNEs brought transfer pricing policy making in at the strategic planning level compared to only 16% of Dutch and 22% of UK owned MNEs.

Why do German firms and Japanese firms (38% at strategic planning level), who experience relatively less stern penalty regimes, place so much important on transfer pricing in the decision making process? Perhaps the answer to this question relates to the cultural factors, for example as suggested by Borkowski (1990) above.

- **Transfer Pricing for Management Purposes**

Jacob (1995) carried out a study investigating the use of transfer pricing for tax management purposes by measuring the volume of transfers of US-based MNEs. He attempted to distinguish between the use of operational methods to decide the location of income and the accounting manipulation of transfer prices. The study involved investigating two different periods: the pre-US 1986 Tax Reform Act years 1982-1984 and post period, 1988-1990. The conclusions indicate that companies with substantial intra-firm sales pay lower global taxes than otherwise similar enterprises in both periods. The former types of firms, however, appear to have paid less taxes in the later period. This result is consistent with global tax minimisation through transfer pricing in both periods (Jacob, 1995). In addition, the profitability differences between US and foreign operations are consistent with the management of transfer pricing for tax reasons in both periods (Jacob, 1995).

Hoshower and Mandel's (1979) study, however, presents different findings to those of Jacob in the examination of transfer pricing policies of diversified US-based multinationals. The conclusion they reached was that: "A significantly greater number of diversified, multinational, US-based firms locate their transfer pricing decisions at the divisional rather than the central corporate level. This is consistent with the policy of decentralised management."

- **Financial Outcomes of Setting Transfer Prices**

Cravens and Shearon (1997) looked away from the actual transfer pricing method, instead

and the number of countries in which MNEs operate in the 'tax management model' provides compelling support for transfer pricing policy affecting financial outcomes." Transfer pricing methods appeared insignificant and attempts at modelling the results of earlier research failed to find a comprehensive set of environmental or internal methods which could explain transfer pricing methods. The main conclusion was that the dollar value of transfers remained a significant variable of financial outcomes. Cravens and Shearon (1997) finished by saying: "The significance of the foreign sales in the return on assets model rather than in the total tax model may indicate that it is a variable relating more to competitive position than managing the total tax burden."

Overview of the Empirical Literature

The selection of factors which affect TPM choice adopted by the empirical studies in this chapter varied. In light of this variation and with recognition of the different research methods used, for example questionnaires and interviews, the results of each study must be interpreted according to the depth and scale of research undertaken.

By carrying out a meta-analysis of multinational transfer pricing research, Borkowski (1996) attempted to interpret which factors most significantly affected TPM choice. Borkowski (1996) examined empirical research, carried out over the previous 20 years, relating to MNEs based in the US. Due to the inconsistent way in which those studies had been carried out, Borkowski (1996) found that meta-analysis was limited. Inconsistencies noted included

The conclusion: "Only two factors (size and industry) were reported with enough statistical data for meta-analyses supported the large corporation/market-based method relationship, and were inconclusive regarding industry (type)" (Borkowski, 1996).

Ability of Tax Authorities to Collect Their "Fair" Share of Tax

This section is concerned with a quick overview of the behaviour of governments to MNEs with regard to ITP. According to Plasschaert (1994): "Governments aim at maximising the country's share of the benefits which derive from international transactions." This is true to a lesser extent when one considers the lesser developed nations who are not as equipped to understand and control transfer pricing exploitation (Plasschaert, 1994). In Eastern Europe, however, as Atkinson and Tyrrall (1997) pointed out, as the economic climate is improving, transfer pricing legislation is being introduced. They noted the Ukraine and Russia as examples of where this is the case.

Whether the expertise exists to apply transfer pricing rules is disputable, but aggressive application may be used to offset this inexperience. MacDonald (1997) used Mexico as an example of where this has been the case, with a new law having been introduced which assumes all transactions between related parties are not at arm's length. MacDonald (1997) noted: "The recent crackdown has translated into tough new fiscal laws making it virtually impossible for companies to take advantage of low tax jurisdictions anywhere in the world."

The governments who are better furnished to understand international trading, are expending enormous resources addressing the issue of ITP. This appears to have reached a high pitch in some countries, for example in the US. Zach (1993) commented on the US's apparent obsession with detail: "There is a trend among the current generation of lawmakers to strive for a preciseness that is impossible. In the pursuit of perfection, this often ignores the commercial realities faced by corporations, including problems of administration and compliance."

- Legal Restraints

Although there is a huge commitment to resolving the transfer pricing dilemma, unfortunately the courts are still facing problems resolving disputes arising in complex cases. "They (the IRS) also found that the length of time it took the Revenue authorities to build up a case showing that there were transfer pricing irregularities was such that they were often too late to take any action" (Bennett, 1996). The desire may be strong to collect taxes but this 'legal' weakness is having a profound effect on the confidence of authorities to administer sound rulings. In some cases they overreact; "thus the eradication of abuses may occur at the cost of additional regulations, which excessively constrain those enterprises, whose ways of conducting business are beyond reproach" (Plasschaert, 1994).

- The Power of Stricter Jurisdictions

Humphreys (1994) concentrated on the problem of transfer pricing in Canada where taxes are among the highest in the world. He also made reference to the US as the country most advanced in transfer pricing and how this has fuelled the major trading partners to introduce some level of regulation or definition on the subject. Countries he highlighted as being

effected include: Australia (Elliott, 1997), Belgium, Denmark, France, Germany, Italy, Japan, the Netherlands (Groenen and Spierondonk, 1994), Spain and the UK. In addition, Korea, Poland and New Zealand (On the tax borderline, 1995) are countries that have increasingly demanded verification of arm's length prices.

Out of the countries mentioned above, those countries introducing more rigid and severer regulations, for example Canada, France and the UK, have led the MNEs based there to increase the importance of transfer pricing in their decision making (Ernst and Young, 1997a). Alternatively, the stricter jurisdictions could be identified by a greater percentage of firms located there who find it necessary to prepare documentation: 78% of firms in the US, 61% in Australia, 57% in Canada 51% in Japan and 50% in UK (Ernst and Young, 1997a). The actual number of investigations appear to be highest for companies based in Australia, Canada, the UK and the US. According to Ernst and Young (1997a): "The fewest examinations are conducted in jurisdictions where well-defined regulations do not exist, for example Sweden."

Jim Marshall (in On the tax borderline, 1995), Head of International Tax at KPMG said: "International groups must expect to have their pricing policies reviewed by the tax authorities of the countries in which they trade, and must be prepared to document and defend those policies."

Requirements on MNEs are expanding. Comprehensive audits are being carried out by better trained tax inspectors, and harsh penalty regimes are being introduced (Atkinson and Tyrrall, 1997). Although Arpan (1988) made the following comments in 1988 it still remains true

today: "The heyday of transfer pricing manipulation is probably over, but transfer pricing will remain highly significant for multinationals and their financial and accounting staff."

Following Chapters

This thesis is concerned with looking at what attempts have been made to control ITP. From the above it can be seen that regulations and increased audit attention have been a part of this control and the following chapters will go into much more detail. Chapter two discusses the internationally accepted arm's length principle (ALP), the foundation on which a majority of countries have built their regulations. The essay looks at the faults of ALP, its inapplicability in a wide number of cases, particularly those involving intangible goods, but also the lack of realistic alternatives (the theory of global formulary apportionment) available.

Chapter 5 looks at the harmonisation of opinions on the treatment of ITP of the two core bodies, the OECD and the US, and the two following chapters examine their influence world-wide, with a case-study on the UK modernisation of transfer pricing legislation.

The remaining chapters are concerned with the use of advance pricing agreements (APAs), agreement in advance of acceptable transfer prices, and double taxation treaties, governments agreeing their share of the MNE groups global profits, as ways to solve ITP disputes.

Research Methods

The research carried out in this thesis has largely been desk-based. The key statutes used in research were as follows:

Year	Country/ Organisation	Statute	Contents
1979	OECD	OECD Model Taxation Convention on Income and Capital	Article 9 - enshrines ALP principle
1984	OECD	Transfer Pricing and Multinational Enterprises: Three Related Issues	Transfer pricing guidelines
1988	US	A Study of Intercompany Pricing	The White Paper - transfer pricing regulations.
1988	UK	Income and Corporation Tax Act	S770-773 - transfer pricing rules
1991	US	Revenue Procedure 91-22	Advance Pricing Agreements.
1992	US	Proposed Regulations	Transfer pricing of intangible property
1993	US	Temporary Regulations	Transfer pricing of intangible property.
1994	OECD	Transfer Pricing for Multinational Enterprises Discussion Draft Part One	Guidelines on transfer pricing methods.
1994	US	Final Regulations	Final transfer pricing regulations.
1995	OECD	Transfer Pricing for Multinational Enterprises Discussion Draft Part Two	Guidelines for intangibles and administrative issues.

1995	CECD	Transfer Pricing for Multinational Enterprises and Tax Administrations.	Final version of transfer pricing guidelines
1996	US	Revenue Procedure 96-53	Advance Pricing Agreement Procedures.
1997	UK	Modernisation of Transfer Pricing Legislation	Incorporating OECD guidelines into legislation.

In addition, there were interviews with a small number of transfer pricing specialists:

Name	Title	Company/Authority	Date of Interview
I.F. Dykes	Tax Manager	Deloitte and Touche, Birmingham	April 1998
A.J. Hickman	International Specialist, Competent Authority Specialist	International Division, Inland Revenue, London	May 1998
S. Jonsson	Principal Consultant	KPMG Tax Advisers, KPMG, Birmingham	May 1998
C.D. Rolfe	International Tax Partner, Chairman - Transfer Pricing Group	Coopers and Lybrand, London	April 1998

ARM'S LENGTH PRINCIPLE (ALP)

The arm's length principle (ALP) has become the most popular standard world-wide for setting transfer prices. The US first introduced ALP in 1935 with the issue of Section 482 regulations (which were formally introduced in the Internal Revenue Code in 1954) and the most recited interpretation of the ALP is contained in Article 9 of the OECD Model Tax Convention:

"[When] conditions are made or imposed between ... two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."

Since introducing the ALP, the US has continued to play a dominant role in the standardisation of transfer pricing legislation, along with the OECD. Both have issued material regularly on international transfer pricing (ITP) among related parties and both believe in the basic theory of ALP and support the predominant adoption of the traditional transaction methods described later in this chapter.

Arguments for the adoption of such an approach includes the treatment of related enterprises as if they were independent of one another. This ensures that focus is solely on the properties of the trade, as would be the case with independent enterprises and, as such, allows greater comparison of transactions between different parties and a more equal approach to the taxing of independent and related enterprises.

On the other hand, to remove any acknowledgement of advantages existing by being a multinational enterprise, for example economies of scale, distorts the true arm's length price of a transaction. Lester (1999) noted that, "the arm's length principle fails for controlled transactions because the special advantages created by these transactions are unique or immeasurable". According to Arnold and McIntyre (1994): "Academics have claimed that ALP necessarily produces improper results in some cases, because it cannot account for the profits that a group of related corporations typically enjoys from conducting an integrated business." Instead, related companies are forced to pretend they have only the same advantages as an independent company carrying out a comparable independent transaction. OECD (1995) admits that this is considered one of the criticisms of ALP.

Another criticism, a practical difficulty, is that there are circumstances when transactions amongst related parties will not exist in a situation involving independent enterprises. The OECD (1995) uses the example of the sale of an intangible as a prime example of such. Lester (1999) said that the unique nature of these transactions creates a wide price range which makes the market price uncertain.

As far as the US introducing the ALP to prevent the manipulation of transfer prices, Lester (1999) noted that the ALP has actually resulted in the avoidance of US taxes. Lester (1999) found that the US loses at least \$2 billion a year through tax evasion under the ALP.

A number of criticisms of the ALP have been touched upon here and other problems are apparent in later chapters, particularly with the narrow applicability of the different ALP transfer pricing methods (TPMs). In addition, chapter 5 highlights the overwhelming documentation burden on taxpayers and tax authorities and the adoption of transfer pricing penalties.

- **Guidance Applying ALP**

The ALP methods adopted by the OECD, the US and most of the world are fundamentally associated with comparing the related transactions of MNEs with the independent transactions of autonomous enterprises. The OECD guidelines and the US regulations both offer guidance on carrying out comparability analysis and this will be discussed in more detail in Chapter 5 (Transfer Pricing Harmonisation).

To have an idea of the guidance offered by the US and OECD, however, it is helpful to look at one example. This is the utilisation an arm's length range, a range containing a number of acceptable profit outcomes, demonstrating that there are a number of occasions when the application of a method will create a selection of acceptable results. As OECD (1995) noted, transfer pricing is not an exact science and so the actual determination of the transfer price to be used in any one case requires the taxpayer to exercise good judgement.

Traditional Transactional Methods

In applying the ALP there are two different approaches that can be used to determine acceptable transfer prices, transaction-based methods and profit-based methods. This chapter will look at the former, viewed as the most direct technique and customarily preferred. The next chapter analyses the theory behind and use of profit-based methods.

The US promoted three traditional methods in its Section 482 regulations adopted in 1968. The regulations allow the differences between controlled and uncontrolled transactions to be traced directly to the activities between the inter-related companies. In the (frequent) absence of directly comparable companies, another criticism regularly sited of the ALP, the emphasis falls on finding other significant procedures to indicate activities are at arm's length. These approaches, direct and indirect, are reflected in the traditional transaction methods below.

- Comparable Uncontrolled Price (CUP) Method

CUP is the most direct determination of ALP, preferred by both the IRS and OECD who are in agreement that every effort should be made to employ it.

The method compares the sales price for goods and services in an uncontrolled transaction with those in a controlled one. Any difference in prices may indicate that conditions are not arm's length, and that it may be necessary to substitute the controlled transaction price for the uncontrolled one.

The OECD guidelines note that transactions are comparable if one of two conditions are met:

a) none of the differences between the transactions being compared or between the enterprises undertaking those transactions could materially affect the price in the open market; and b) reasonably accurate adjustments can be made to eliminate the material effects of such differences.

According to Section 482-3 of the US Internal Revenue Code (IRC): "Comparability under this method depends on close similarity with respect to these factors, or adjustments to account for any differences. Factors which may be particularly relevant include--

- a) Quality of the product;
- b) Contractual terms, (e.g. scope and terms of warranties provided, sales or purchase volume, credit terms, transport terms);
- c) Level of the market (i.e. wholesale, retail, etc.);
- d) Geographical market in which the transaction takes place;
- e) Date of the transaction
- f) Intangible property associated with the sale;
- g) Foreign currency risks; and
- h) Alternatives realistically available to the buyer and seller."

This may sound a relatively simple method to apply, however, according to Schwartz et al (1995), CUP is extremely factual requiring numerous invoices to be reviewed to determine comparability. In reality, it is very unlikely that a direct substitution can take place because transactions are rarely perfectly comparable.

CUP was more suited to the relatively less complex transactions on the 1980's. Atkinson and Tyrrall (1997) used the changing structure of the car industry as an example of how the method has become less appropriate. They noted that in the 1980's it was possible to use independent distributors as a comparator for other dependent car distributorships in the UK. Now that all the major car manufacturers have developed their own dependent distributor networks, finding such an arm's length comparability becomes increasingly challengeable.

Schwartz et al (1995) noted: "Computing the number and amount of the adjustments that need to be made is extremely complex in most cases. The required level of detail makes a study of the CUP method the most expensive to complete, but the evidence is the most compelling if it exists."

Arnold and McIntyre (1994) found CUP to be most widely used for goods sold on public commodity markets, such as wheat, and in pricing oil and iron-ore. They found it was useful for pricing manufactured goods that do not depend substantially for their value on special know-how or brand names.

- **Resale Price Method (RPM)**

After CUP, the resale price method (RPM) is sited equal second with the cost-plus method in the US hierarchy of preferences. OECD (1994) describes RPM as: "A transfer pricing method based on the price at which a product has been purchased from an associated enterprise and is then resold to an independent enterprise. The resale price is reduced by the

resale price margin. What is left, after subtracting the resale price margin, can be regarded, after adjustment for other costs associated with purchase of a product, as an arm's length price of the original transfer of property between associated enterprises.

According to Section 482-3 of the US transfer pricing regulations: "Comparability under this method is less dependent on close physical similarity between the products transferred than under the CUP method. Comparability is particularly dependent on similarity of functions performed, risks borne, and contractual terms, or adjustments to account for the effects of any such differences.

Factors which may be particularly relevant include--

- a) Inventory levels and turnover rates, and corresponding risks, including any price protection programmes offered by the manufacturer;
- b) Contractual terms (e.g. scope and terms of warranties provided, sales or purchase volume, credit terms, transport terms);
- c) Sales, marketing, advertising programmes and services, (including promotional programmes, rebates, and co-op advertising);
- d) The level of the market (e.g. wholesale, retail etc.); and
- e) Foreign currency risks."

The OECD view RPM as most useful when applied to marketing operations, possibly because the emphasis is not on a product being sold, giving preference to other attributes of comparability. Minor product differences are less likely to have as material an effect on the profit margins as they do on price. Hence, fewer adjustments than with CUP are normally

needed to account for product differences when making comparisons between associated and independent enterprises.

- **Cost Plus Method**

The cost plus method, last of the traditional transaction methods, as identified by OECD (1994): "Takes the cost of production and adds the appropriate gross profit margin. This mark-up should be determined by reference to the mark-up earned by the manufacturer's sales to unrelated parties for the same or similar transactions."

According to Section 482-3 of the US IRC: "Factors that may be particularly relevant to this method include--

- a) The complexity of manufacturing or assembly;
- b) Manufacturing, production, and process engineering;
- c) Procurement, purchasing, and inventory control activities;
- d) Testing functions;
- e) Selling, general, and administrative expenses;
- f) Foreign currency risks; and
- g) Contractual terms (e.g. scope and terms of warranties provided, sales or purchase volume, credit terms, transport terms).

As with RPM, the cost plus method relies little on the actual product in question and more on other factors of comparability. OECD (1994) suggested that the cost plus method is probably most useful where semi-finished goods are sold between related parties, "who have concluded

joint facility agreements or long term buy-and-supply arrangements, or where the controlled transaction is the provision of services".

Complying with the Methods

Though these methods may appear very straight forward, to prove the adoption of any one TPM means producing a lot of documentation that takes up a lot of time and can be very expensive. In addition there is no certainty that the tax administrations will accept the TPM chosen and therefore no certainty against being penalised.

Bucks and Mazerov (1993) and Mazerov (1994) criticise the US use of ALP harshly, listing these following four shortcomings:

"The arm's length pricing system:

- costs the federal and state treasuries billions of dollars annually in unjustified and unnecessary revenue losses: a public policy failure that borders on the scandalous;
- diverts too many scarce resources, both public and private, to tax planning, complex accounting and auditing practices, and lengthy litigation;
- creates inequities in tax payments and thereby tilts the competitive playing field by allowing global corporations to play transfer pricing games that entirely domestic firms are not even eligible to enter; and
- fails to guarantee any substantial degree of international uniformity in the division of income for tax purposes."

As shown above, the ALP has a number of faults and this is not helped by the fact that the traditional transaction methods will not be appropriate in a number cases, not least that there may not even be any comparable transactions available. The next section departs from the ALP to look at an alternative method, global formulary apportionment, to help answer the question why ALP is still so widely acknowledged in the face of so much criticism.

Global Formulary Apportionment (GFA)

The US were the earliest pioneers of formula apportionment, primarily recognising the fundamental issues in dividing income of related corporations involved in interstate commerce (Bucks and Mazerov, 1993). The approach was then considered with a view to applying it on a global scale as international business transactions became more significant. Support in the US for GFA, according to Sayer (1995) who quoted Senator Byron Dorgan, is based on the idea that it is a convenient way of raising revenue without taxing voters.

The IRS has not been successful with ALP transfer pricing cases taken to court. In comparison, they have won a majority of their internal cases and the US Supreme Court has upheld the validity and fairness of the formulary apportionment method (Bucks and Mazerov, 1993). Two revolutionary states, North Dakota and Montana, have so far been successful in administering the international apportionment system (Bucks and Mazerov, 1993). With a worldwide adoption of GFA it could be possible for jurisdictions to experience a similar level of success with court cases involving GFA as North Dakota and Montana.

The OECD (1995) have identified global formulary apportionment (GFA) as:

"A method which would allocate global profits of a multinational enterprise group on a consolidated basis among the associated enterprises in different countries on the basis of a predetermined and mechanistic formula. The formula would most likely be based on some combination of costs, assets, payroll and sales."

The US recommended GFA as a mandatory taxpayer reporting system, saying it was the method of accounting that best fitted the reality of world trade conducted within a global enterprise. It was argued that an MNE group must be considered on a consolidated basis to reflect the business realities of the relationships among the associated enterprises of that group (OECD, 1995).

The OECD (1995) argued in return that, "predetermined formulae are arbitrary and disregard market conditions, particular circumstances of individual enterprises and management's own allocation of resources". In addition, they also noted that the ALP is better equipped to deal with changing exchange rates, differing accounting standards and multiple currencies and hence that GFA was not a more 'realistic' transfer pricing system.

The main advantage of GFA, however, is that considerably less 'staff' hours are necessary to complete a GFA audit that covers all international issues of an MNE than to complete an international arm's length audit, which might be limited to only a portion of a company's related-party transactions (Bucks and Mazerov, 1993). OECD (1995) suggested that this cost

saving, and much more, would be needed to fund the: "Intolerable compliance costs and data requirements because information would have to be gathered about the entire MNE group and presented in each jurisdiction on the basis of the currency and book-keeping and tax accounting rules of that particular jurisdiction."

It would take an enormous effort worldwide to launch GFA as an alternative to ALP to prevent the huge scale double taxation which could arise over the use of conflicting methods (GFA versus ALP) and alternative interpretations of the GFA. The OECD (1995) noted that to implement such a system, "would require substantial international co-ordination and consensus on the predetermined formulae to be used and on the composition of the group in question". Deciding on these things "would be time-consuming and extremely difficult and if all the major countries failed to agree to move to GFA, MNEs would be faced with the burden of complying with two totally different systems." Sayer (1995) quoted Michael Schwartz on the idea of the US using GFA: "If the US adopts formulary apportionment, it would be a nightmare dealing with other governments." GFA, therefore, appears to be advantageous to neither tax administrators nor taxpayers alike.

ALP as the "Best Option"

Because of the disadvantages of GFA (even more are listed in Chapter III of the 1995 OECD guidelines), clearly outweighing the advantages, countries are unwilling to make change away from ALP. It has taken a long time for the ALP to become so widely accepted among

countries and it is very unlikely that this opinion will be swayed in the absence of any real alternative.

The OECD (1995) admitted that the ALP will not always be straightforward to apply in practice, but, in defence of ALP, said that it generally does produce appropriate levels of income between associated enterprises acceptable to tax administrations.

OECD (1995) also noted the following: "A move away from the ALP would abandon the sound theoretical basis described above and threaten the international consensus, thereby substantially increasing the risk of double taxation." Experience under the ALP has become sufficiently broad and sophisticated to establish a substantial body of common understanding among the business community and tax administrations. This experience should be drawn on to elaborate the ALP further, to refine its operation, and to improve its administration by providing clearer guidance to taxpayers and more timely examinations.

CHAPTER 3.

PROFIT-BASED TRANSFER

PRICING METHODS

PROFIT-BASED TRANSFER PRICING METHODS

"Traditional transaction methods are the most direct means of establishing whether conditions in the commercial and financial relations between associated enterprises are arm's length. However, the complexities of real life business situations may put practical differences in the way of the application of the traditional transactional methods." (OECD, 1995)

When the products being sold incorporate valuable intangible property, where there is no analogous data available or adequate information, it may become essential to "address whether, and under what conditions, other methods may be used" (OECD, 1995). This suggests investigation of profit-based methods.

These methods "examine the profits that arise from controlled transactions of one or more of the associated enterprises participating in those transactions". They must be consistent with OECD guidelines and compatible with Article 9 of the OECD Model Tax Convention. The methods identified are the profit split method, the comparable profits method (CPM) and the transactional net margin method (TNMM).

Profit Split Method

The profit split is probably the most accepted of the profit-based methods and hence attracted the least controversy. The OECD July 1994 draft guidelines first introduced the method. As

noted by Arnold and McIntyre (1994), the method is typically employed when none of the three traditional transactional methods can be applied.

- Division of Profits

The process concerns the allocation of consolidated profits attributable to intercompany transactions on the basis of an objective measure of their economic contributions had their transactions been between arm's length parties. Each party's share of the combined profit or loss depends significantly on the functions performed, risks assumed and resources employed (Mawani, 1997). An example of an 'objective measure', or arbitrary ratio, could be one which relates to the proportion to capital employed. Atkinson and Tyrrall (1997) pointed out that this profit split procedure will inevitably encompass a measure of subjectivity, but can be acceptable. This can be explained, perhaps, by the fact that since similar firms are evaluated in deciding the arbitrary ratio, then neither is likely to be left with "an extreme or improbable profit result". According to OECD (1995): "This aspect can be particularly important when analysing the contributions by the parties in respect of the intangible property employed in the controlled transactions (see Chapter 6). This two-sided approach may also be used to achieve a division of the profits from economies of scale or other joint efficiencies that satisfies both the taxpayer and tax administration."

- Functional Analysis

To work out, in more detail, how much each of the parties involved have contributed to the transactions it is necessary to carry out some functional analysis. The different types are described in detail in Chapter I of the OECD 1995 guidelines and firms are expected to carry this analysis out to support the use of any of the transfer pricing methodologies. Mawani (1997) highlighted the use of residual analysis and contribution analysis.

Firstly, a residual analysis divides the combined profit of the related parties in two stages. Initially, each party is allocated a level of profit to provide an income appropriate for the type of transaction in which it is employed. Market data could assist in the division of this income. According to OECD (1995): "In the second stage, any residual profit (or loss) remaining after the first stage division would be allocated among the parties based on an analysis of the facts and circumstances that might indicate how this residual would have been divided between independent enterprises."

Secondly, contribution analysis divides the overall profit or loss based on the relative value added functions performed by each party. This process of division is aided as much as possible by external market data of comparable transactions between unrelated parties. Generally, according to OECD (1995) the profit to be divided is the operating profit. In exceptional cases it may be necessary to divide the gross profit and deduct any expenses incurred which are consistent with the activities carried out or risks born. The OECD (1995) gives the following example when this may be necessary: "In the case of an MNE that engages in highly integrated worldwide trading operations, involving various types of property, it may be possible to determine the enterprises in which expenses are incurred (or attributes), but not to accurately determine the particular trading activities to which those expenses relate. In such a case, it may be appropriate to split the gross profits the expenses incurred in or attributable to each enterprise."

- Use of profit split method

According to Stitt (1995): "While an interesting concept in theory, it will only be valid where all the relevant revenue authorities agree on the underlying basis for allocating the profits. It may, therefore, be a useful approach in mutual agreement proceedings (see Chapter 9) or for

companies seeking multilateral advance pricing agreements where TPMs are discussed in advance (see Chapter 8)." In addition, the method is often used, on an informal basis, by tax authorities in negotiating disputes with taxpayers through an internal appeal procedure (Arnold and McIntyre, 1994).

It should be noted that the profit split method is more appropriate than other transfer pricing methodologies when the activities of the affiliates of a MNE are very unsegregated and hence transactions difficult to measure individually. The benefit of this method is that it does not rely directly on closely comparable transactions, and can obviate the need to establish transactions between independent enterprises. If a group of affiliated companies has more than one product line, the profit-split method could be applied separately to each product line (Arnold and McIntyre, 1994).

OECD 1995 guidelines stated that not needing closely comparable transactions shows that the profit split method offers flexibility, in particular the method is acceptable because it takes into account: "specific, possibly unique, facts and circumstances of the associated enterprises that are not present in independent enterprises, while constituting an arm's length approach to the extent that it reflects what independent enterprises reasonably would have done if faced with the same circumstances." On the other hand, however, it would be difficult to collect and maintain information on the combined revenues and costs for the transactions involving two or more related companies situated in different countries. The OECD (1995) noted that this would require stating books and records on a common basis and making adjustments in accounting practices and currencies. Similarly, it would be difficult to highlight the contributions of the different parties or identify the operating expenses and allocate between the transactions and relevant parties.

- Japanese Profit Split Method

In Japan the authority to use the profit split method is found in the 1986 Special Taxation Measures Law Enforcement Order, Article 39-12, Special Provisions for Taxation of Transactions with Foreign Affiliated Persons. According to Clark and Dodge (1997), however: "To the IRS the Japanese profit split is essentially formulary apportionment, even in the guise of a profit split method, is not a specified method under US transfer pricing rules." This illustrates inter-country conflict even on the basic definition of a universally accepted method. One of the problems listed by Clark and Dodge (1997) is that the Japanese National Tax Authority (NTA) accepts the use of internal data as opposed to the US regulations which point out that such data is far less reliable than external comparable data. OECD (1995), however, noted one weakness with regards to external data, used in deciding the contributions of each related firm involved, is that any information collected "will be less closely connected to those transactions than is the case with other available methods". In addition, companies are often very limited by the actual amount of internal and external data available to them and furthermore, independent enterprises are generally, not going to use the profit split method.

- US Versus OECD Profit Split Methods

In the US, the authority was initially written in the 1993 temporary regulations and the S482 regulations contained a list of three conditions which must be met before being allowed to use one of the three profit split methods available (see Appendix 3). These conditions are that: both controlled taxpayers own "valuable" non-routine intangible property; there are significant transactions between controlled taxpayers; and certain administrative requirements are followed.

Unlike this restriction on the use of the profit split method in the US regulations, the OECD guidelines show a more favourable approach and express a strong preference for the use of the profit split method over the transactional net margin method (TNMM) (the other profit-based method allowed). Greenhill and Bee (1996) recorded that the profit split method will produce a very different result than that obtained under any of the other methods specified in either the Section 482 regulations or the guidelines. An example, from Greenhill and Bee (1996) to illustrate this point is that the guidelines would allow a taxpayer to base its profit split analysis on projected profits, seemingly without regard to actual profits realised; such an approach would not be permitted under the Section 482 regulations.

Another failing is in the required disclosure of the use of the profit split method, included in the US penalty provisions, which makes this method one to be used only if no other method is appropriate (Schwartz, Zimmerman, Peterson and Seickel, 1994).

With regards to dealing with intangible property (Chapter 4), Boatman (1997) found that the profit split method appeared: "The most promising candidate for an arm's length analysis where both parties to the transaction own valuable intangible property, since it allows for excess returns on both sides of the transaction."

Comparable Profit Method (CPM)

The comparable profit method (CPM) was the most controversial of the main transfer pricing methodologies. The US first introduced CPM in the 1988 White Paper and since that time it has received a lot of criticism, not least that it represents a departure from the arm's length

pricing standard. This section will look at what is the CPM, the advantages and disadvantages of such a method, how it has been greeted by everyone outside the US and how those feelings have (or have not) changed over time.

OECD (1994) defined CPM as looking at: "The profit levels earned by uncontrolled parties which are considered comparable based on acceptable criteria, such as size and line of business." Alternatively CPM could be describes as comparing the period percentage operating profit in controlled subsidiaries with the percentage in similar uncontrolled entities on a whole company basis. If comparing CPM to the OECD's comparatively recent transactional net margin method (TNMM) (see next section), it can be seen that TNMM compares the operating profit on transactions rather than on a whole company basis (Atkinson and Tyrrall, 1997).

- Acceptable Range

Furthermore Coopers and Lybrand (1993) state that the transfer price must "...result in an operating profit within a range of operating profits of comparable companies". This range must be established initially by the taxpayer, for itself or a related party and if results fall within that range, then its transfer prices will be accepted by the tax authorities (Arnold and McIntyre, 1994). KPMG has found that for most companies the range of results under CPM is broad enough that most companies can satisfy this method (Schwartz, Zimmerman, Peterson and Seickel, 1994). If results do fall outside the acceptable range then the IRS are likely to adjust the transfer prices so that the profits end up fall within the range, probably in the middle.

Ogum and Kim (1995) suggest an number of steps in order to construct acceptable transfer prices using the CPM (see Appendix 3).

- Advantages and Disadvantages

The main advantages are that it involves the easiest and cheapest type of analysis to perform. Partly this is because operating profit data is often readily available from published accounts. However, it is regarded by the OECD as providing a less satisfactory standard of comparison since extensive adjustments to the profit and loss and balance sheets may be required (Atkinson and Tyrrall, 1997). Ian Dykes, Tax Manager at KPMG, Birmingham, (1998 interview) said of CPM:

"Quite easy to get the information and put it together. That is the point, it is the ease of getting the information. It is quite possible that there are transaction comparables out there which would be better, more you could hang your hat on, more easily is a third party comparable, but finding them is a nightmare, businesses are not prepared to give that sort of information. Which means that where there is a lack of that sort of information you are almost invariably going to fall back on CPM."

Clark and Dodge (1997) noted, however, that the Japanese NTA were concerned with the comparable independent enterprises being used in a CPM analysis because they believed that these comparisons would not reflect the "mutual dependency that exists between a Japanese parent and its US subsidiaries".

It is more complicated to set transfer prices with this method, but easier to check the results (Schwartz, Zimmerman, Peterson and Seickel, 1995).

- Not An Arm's Length Method

This chapter has already mentioned that the CPM is accused by some as not an arm's length pricing method, the basis of this argument is on the fact that profits do not necessarily directly reflect the price of transactions with associates. France and Germany have been two of the "loudest" countries to make this opinion known (Rehder, 1996). The US Treasury Department tried to ease some of the concern of France and Germany by drawing attention to the areas of the IRS regulations which restrict the IRS' allowed usage of CPM, for example the introduction of an arm's length range (Hembrey, 1995a).

Arnold and McIntyre (1994) criticised the arm's length standard for being very vague and, arguably at least, accommodating pricing methods, such as the profit split method as well as CPM, that seem closer to formulary apportionment than to the arm's length method. The Business and Advisory Committee (BIAC) also held the view that CPM does not represent an arm's length method. Elliott (1995) said that their objective was to make sure that the arm's length standard would continue to be recognised as the preferred method. This begs the question was there ever any doubt that the traditional transaction methods would not be favoured. There is no data to suggest this would have been the case. However, Ian Dykes (interview 1998) did say that, "as a method in practice we use CPM almost invariably" (although it is not officially an acceptable method in the UK). Perhaps the question is to what extent firms go to initially to try and use the traditional methods as opposed to settling straight away for CPM, perhaps the "easier" option.

Looking at the concerns of the Japanese, Tadaki (1993) quoted Masaki Miura, deputy commissioner of the international affairs department at the NTA Agency, who said, "although the CPM is just one of the (four) methods, we are afraid of frequent reliance on, and frequent

usage of, the CPM". Ernst and Young 1997's Transfer Pricing Report recorded the usage of different methods used for all types of intercompany transactions. The result demonstrates that the traditional methods remain the most commonly applied.

Table 3.1

Country	CUP	CUT	RPM	Cost	CPM	TNMM	PS	Cost	HP	Other	NS
Australia	72	8	20	68	16	4	12	4	16	52	32
Canada	48	4	32	80	16	-	8	8	8	40	24
France	20	8	28	56	12	4	20	24	20	24	24
Germany	28	8	20	88	12	8	8	8	-	52	28
Italy	20	-	12	48	-	-	8	16	-	56	28
Japan	23	8	-	31	-	15	15	-	46	-	-
Korea	39	2	5	36	5	9	7	-	30	-	-
Netherland	16	12	16	76	8	4	8	24	8	44	28
Sweden	12	4	16	52	12	8	20	20	12	48	40
Switzerland	56	4	16	84	12	-	12	12	12	36	40
UK	49	16	19	62	14	3	16	8	19	27	16
US	56	27	26	65	21	4	14	22	15	37	35

Percentage of Methods Used For All Types of Transactions

Country is the country in which companies have their headquarters

PS = Profit Split HP = Historical Practice NS = Not Stated

The first Cost = Cost Plus The second Cost = Transactions at Cost

Ernst and Young, 1997 Transfer Pricing Report

According to the above table CPM is the second favoured profit based method after profit split. CPM is the fifth preferred method, in you ignore the "other" less conventional methods, proving that CPM is used by a large number of companies, but not in place of the traditional, more widely accepted, transaction methods.

Ernst and Young (1997) recorded that CPM is, generally, not used in preference to any of the other methods depending on the types of transactions. This is illustrated in the table below. The "other methods" have not been included.

Table 3.2

	CUP	CUT	RPM	Cost	CPM	TNMM	PS
Sale of finished goods	31	4	24	36	11	4	8
Sale of raw materials	28	1	11	45	9	3	5
Administrative/managerial	9	3	3	49	3	1	2
Technical Services	12	5	2	49	2	2	3
Commission for sale of goods	22	3	9	23	6	2	8
Intangibles	23	12	5	15	9	2	6
Financing	25	6	2	17	4	2	2

Percentage of Methods Used by Type of Transaction

Ernst and Young, 1997 Transfer Pricing Report

CPM is only more popular than CUT and TNMM, and then not in all cases, out of the methods listed above. Do the authorities opposing the use of CPM really have anything to worry about?

Hembrey (1995a) stated that MNEs were fearful that the use of CPM would require subsidiaries to calculate "comparables" for a large number of individual products, depending on how the method was employed by the different national tax authorities. This problem is more obvious when it is pointed out that some companies buy tens of thousands of products each year from related companies in varied locations abroad. Hembrey (1995a) said that MNEs predict that any requirement to calculate many of their purchase prices using profit-based methods would be time-consuming and costly. On the other hand, Andrew Hickman, International Specialist and Competent Authority Specialist at the Inland Revenue, said that companies in the US had greater access to market information than companies in other countries, for example data on tax returns, and, therefore, it will be easier for the CPM method to be applied than the traditional transactional methods. In the absence of comparables, Andrew Hickman showed a concern that companies might be encouraged to use methods considered even more opposed to the ALP, such as formula apportionment.

- US Introduction of CPM

Elliott (1995) explained the adoption of CPM in the 1988 White Paper as an "unfortunate manifestation from the popular belief that foreign subsidiaries (of Japanese parents in particular) were not paying their fair share." The House Ways and Means Committee (in the US) held a number of meetings to research into the claim that foreign subsidiaries were not paying enough in taxes and hence the need to introduce CPM to counter this. The conclusion, according to Elliott (1995), was that: "Some of the companies investigated have been operating in the US for years and have never sent a check to Uncle Sam for 'one thin dime' in corporate income taxes." Hufbauer (1992), however, defended some of these firms, he said that: "Less sinister explanations for the apparent poor performance can be offered: for example, foreign firms may acquire sick US companies at premium prices in the hope of effecting a turn-around, they may incur heavy startup costs in building greenfield plants and distribution systems with large amounts of debt."

Elliott (1995) said that CPM was the manifestation of the US issuing increasingly divergent transfer pricing rules on how the arm's length principle was to be applied. We have seen, from earlier in the chapter, the problems that the Japanese NTA and other tax authorities worldwide have had trying to digest the introduction of this method. MNEs also have had a hard time understanding CPM, particularly because it is a method not considered to adhere to the arm's length standard and hence, foreign to what they have been regulated to abide by.

Elliott (1995) noted : "There has been a chasm between transfer pricing regulations in the US and the OECD which was at its widest and most controversial in 1992 with the publication of US (1992). The US 1992 regulations followed the recommendations of the White Paper and established the use of CPM. The 1993 regulations continued to allow the use of CPM with the

addition to the regulations of the "best method" rules which meant that to use CPM, the favoured traditional transaction methods had to be rejected for whatever reasons before a taxpayer could choose this option.

- Change in Emphasis on US Side

CPM has been used for many years by the IRS in settling transfer pricing disputes (Arnold, 1994). Revisions to S482 regulations published in 1994 allow taxpayers to use CPM under certain conditions in determining transfer prices for sales of tangible and intangible property (Arnold and McIntyre, 1994). France and Germany, in particular, were looking for tighter controls on the use of CPM (Rehder, 1996).

Elliott (1995) pointed out that the most interesting developments, with regards to the US 1994 final regulations and the OECD guidelines, had been the softening in approach by both the US and the OECD towards CPM (although in opposite directions), the added flexibility inherent in both documents, and the USs' support for the transaction-based form of ALP. The US's lessening of enthusiasm for the use of CPM after the 1992 controversy put the use of the method into a more realistic perspective. This is demonstrated by Hembrey (1995a) who quoted a high level IRS official as having said that he expected CPM to be considered the "best method" in relatively few cases. According to Tadaki (1993), however, Japan and the rest of the international community would still fear that its arbitrary use would be both "illogical and unfair".

- Change in Emphasis on OECD/European Side

According to Hembrey (1995b): "Frances Horner, the principal administrator for the OECD's Fiscal Affairs Division, recently said that the OECD draft (Part I of 1995 guidelines) accepts



CPM as a valid arm's length method, but also urges national governments to use CPM as a last resort due to "certain difficulties" in its application." France and Germany were opposed to this allowance unless the report spelt out clear and agreeable restrictions on the use of CPM (Hembrey 1995b). This restriction must have brought some comfort to them. In addition, it has been made clear that the OECD only accepts CPM so far as its use is consistent with the guidelines (Stitt, 1995).

- CPM Conclusion

The Japanese NTA still have significant concerns over the use of CPM by US-based companies since they believe using the method typically results in profits in a US subsidiary even when the transactions are not profitable overall (Clark and Dodge, 1997). One example of the apparent double standard is, according to Clark and Dodge (1997): "In a typical Japanese manufacturer-US distributor situation, the CPM generally requires the distributor to earn a profit and pay US income taxes, even if the transactions are unprofitable on a consolidated basis. In contrast, if the same unprofitable, consolidated business was operated by a US company, with its manufacturing operations located in the US, the company would "be permitted to lose money" and pay no US income taxes."

A section from Elliott (1995) describes the current (now more harmonised) opinions of the OECD and US and a fitting conclusion to CPM:

"The overall approach of both OECD (1994) and US (1994) is that the method appropriate in each individual case should be determined on its own merits. The OECD expresses a preference for the transaction-based methods over profit-based methods and indicated that the latter should only be used in the last resort. However, this approach allows the use of CPM in the appropriate circumstances."

- **TNMM Similar to CPM?**

The OECD (1994) noted that CPM had strengths and weaknesses in terms of the ability to establish whether conditions in the financial and commercial relations of associated enterprises are arm's length. The OECDs' public acceptance of CPM has boosted its use worldwide. The main disadvantage in the past was the lack of acceptance outside the US, the OECDs change in view towards CPM and the introduction of the TNMM method from the OECD, which is quite similar to CPM, will change the general opinion. According to Stitt (1995): "Some commentators have suggested that TNMM is nothing more than CPM with a new name, except that more emphasis is placed on information about the company under review, rather than industry averages or other data not linked directly to particular transactions." To understand this contention it is necessary to know more about TNMM. The following section, therefore, will explain TNMM and discuss its comparability to CPM as well as discuss its use generally and acceptability worldwide.

Transactional Net Margin Method (TNMM)

Transactional net margin method (TNMM) is the second profit-based method, after the profit split method, which the OECD endorses in the 1995 guidelines. The OECD (1995) describes TNMM as examining "the net profit margin relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realises from a controlled transaction". The net margin is equal to the particular products' return on assets or operating income to sales. The benefit of using net margins is that they are less affected by changes to transactions than the price (as needed for CUP).

As well as TNMM being considered alike to CPM, Mawani (1997) said that "this method is similar in its application to the resale price and cost plus methods, except that it focuses on net margins instead of gross margins." According to OECD (1995), the use of net margins is beneficial since they are "more tolerant to some functional differences between controlled and uncontrolled transactions than gross margins". The OECD (1995) shows this by explaining that differences in functions are likely to effect the level of operating expenses and , therefore, enterprises might end up with an extensive range of gross profit margins , but still much similar levels of net profits. On the other hand, there will be factors which will have a greater effect on a taxpayer relying on net margins and not those concentrating on prices or gross margins. The OECD (1995) provides guidance on establishing comparability for TNMM, which they believe is very important to minimise this problem.

The similarity between the resale price and cost plus methods and TNMM means that TNMM must be applied in a manner consistent with them. If these traditional transactional methods are inapplicable then a taxpayer could try and use TNMM. However, Stitt (1995) noted that TNMM depends heavily on the availability of reliable data and, "thus, on the face of it, it is arguable that there would have to be truly exceptional circumstances for a TNMM to be more appropriate than one of the traditional methods.

As with the previous methods, a taxpayer would need to carry out functional analysis of associated enterprises and independent enterprises to establish the comparability of transactions and any adjustments which might have to be made to make the transactions more suitably comparable.

A taxpayer, however, would not be required to determine the functions carried out by more than one of the related parties. Unlike the profit split method, for example, a taxpayer would not have to state the books and record of all participants or allocate costs for all participants (OECD, 1995). This is particularly beneficial for transactions involving complex factors or transactions which are highly specialised.

- Arm's Length Range

From Mawani (1997): "Averaging net margins over several years may control for minor deviations on profits over product life cycles and business cycles. This requires computing a similar longer-run measure for comparable firms undertaking arm's length transactions. Furthermore, the notion of arm's length range is more applicable for TNMM than most other transfer pricing methods, since the range implicitly recognises the reality that the *ceteris paribus* assumption in comparing net margins of two entities is unlikely to be satisfied. The use of a range implies that no adjustments to the transfer price may be required if the appropriate net margin of a tested party falls within the arm's length range."

- CPM and TNMM Compared

CPM and TNMM have clear definitions to discriminate between the two methods, they do, however, drive towards similar conclusions. Simon Jonsson, Principal Consultant at KPMG, Birmingham, noted that the OECD looked at the profit split method more as a method closer linked to CPM than TNMM.

Greenhill and Bee (1996) ascertained that TNMM is very similar to CPM under the Section 482 regulations. They wrote: "Some OECD countries perceive the CPM as only the imposition of industry-wide average returns to a taxpayer's entire business activity, without

any regard to comparability and to factors other than transfer pricing that might ignore profit margins. However, the S482 regulations have explicit comparability standards that apply to all pricing methods. Thus, when properly applied, the CPM and the TNMM should produce substantially the same result.” This view is supported by Ian Dykes, manager at Deloitte and Touche, Birmingham, who said that he "didn't believe, in practice, that there is any difference (between CPM and TNMM)".

Conclusion

We have seen, from the previous chapter in particular, the overriding preference for the use of traditional transactional methods over profit based methods. The introduction and allowed application of the latter methods provides proof of the inability of the former traditional transactional methods to capture all types, if even half, of related transactions. The US and OECD support the idea of using the "best", most suitable method depending on the facts and circumstances of the transactions. Profit-based methods are acceptable above CUP, RPM and the cost plus method so long as they prove to be the optimum recourse.

According to OECD (1995), however, most countries have limited their use of profit-based methods to the profit split method. The guidelines continue by saying that: "Very few countries have much experience in the application of the transactional net margin method and most consider it experimental and therefore prefer to use the profit split method in cases of last resort." This opinion is slowly changing as more countries introduce some form of legislation for the use of TNMM and/or CPM.

CHAPTER 4.

GROWTH OF INTANGIBLE PROPERTY

GROWTH OF INTANGIBLE PROPERTY

Transfer pricing in multinational companies involving intangible property has provided and continues to provide a huge conundrum for tax authorities and taxpayers alike. The seemingly sudden emergence of intangibles has caused a lot of problems for tax authorities trying to police transfer pricing. The table below, taken from Hufbauer (1992), illustrates the rapid growth of international receipts and payments of royalties and license fees for US firms.

Table 4.1

Year	Receipts		Payments	
	Related Firms	Unrelated Firms	Related Firms	Unrelated Firms
1960	590	248	35	40
1965	1199	336	68	68
1970	1620	583	111	114
1975	3526	759	241	192
1980	5695	1170	515	254
1985	4123	1700	467	380
1990	1846	3446	1621	1023

US Firms' International Receipts and Payments of Royalties and License Fees, 1960-90
(millions of dollars)

Hufbauer (1992): Source - Survey of Current Business, various issues.

The table shows that international receipts of royalties and license fees for related firms, from the period 1960 to 1990, has increased by more than 20 times as much. Likewise, payments among related firms has increased by over 46 times as much.

This chapter will give examples of some of the types of intangibles and the problems they introduce, the failed court cases showing how hard it is to prove transfer prices are being manipulated and both the legislation in US and the guidelines of the OECD which have been introduced in an attempt to harness the pricing of intangible property.

- Intangibles defined

King (1994) considered the different types of intangibles and divided them into four broad categories:

1. *Rights* - receiving contracts on favourable terms, and providing contracts, such as mortgage servicing rights;
2. *Relationship* - assembled work force, customer relationships, distributor relationships;
3. *Grouped Intangibles* - goodwill, going concern; and
4. *Intellectual Property* - patents, trademarks, copyrights, and trade secrets or know-how.

The last category of intangibles and setting transfer prices for them, has attracted the most attention from tax authorities. This is largely due to the growth of pharmaceutical companies and their use of patents. According to Nurton (1997), without patent protection, pharmaceutical companies would have no guarantee of a return on the millions of dollars invested in developing a new product. Typically, a small number of products account for a majority of a company's revenues. The importance of patents can be seen when one considers how often drugs often become more widely acknowledged by their brand name than by their "international non-proprietary" name. Nurton (1997) names aspirin, as the best example, a product which made Bayer. This example represents a case involving highly valuable intangibles and this is normally equated with a complete lack of existing comparables. Knowing that medicines are involved, however, one could already have reasonably concluded that there would not be anything similar in existence anyway.

- OECD and Intangibles

In addition, as Price Waterhouse (1997b) highlighted, the OECD list important characteristics for intangible property apart from the actual type. These are: firstly, the form of the

transaction, for example whether there is a license of a sale; secondly the duration and degree of protections; and finally, the anticipated benefits from the use of the intangible property. These need careful consideration when contemplating buying, loaning or selling a (valuable) intangible.

The OECD guidelines had not, up until 1996, considered arm's length pricing for intangible property or the provision of intercompany services (Greenhill and Bee, 1996). The OECD then published an update on April 11, 1996 which brought about considerations for both of the above (OECD, 1996). This extension included an expansion to their existing discussion of intangibles in the 1995 OECD guidelines to distinguish between marketing and trade intangibles:

Marketing intangibles - include trademarks, trade names, customer lists and distribution channels; and

Trade intangibles - are commercial intangibles other than marketing intangibles, for example, those created through research and design.

Boatman (1997) noted that making the definitions more refined had two important implications. Firstly, the question was raised as to whether a distribution subsidiary is entitled to excess returns on its marketing activities or should it be compensated as a service provider. Boatman (1997) concluded that if a distributor were not to enjoy long-term exclusive distribution rights then surely they would not be willing to absorb significant marketing expenditures as arm's length. The second connotation was a recognition that if a firm can create marketing intangibles other than tradenames and trademarks then this surely suggests that intangible ownership cannot be determined by identifying the owner of the enterprise's patents, know-how, and trademarks. This insinuates that ownership can be shared across a MNE. The example used was a distribution subsidiary's expenditure on the development of

superior distribution channels led to the creation of marketing intangible and resulting supranormal profits to the subsidiary despite the parent owning all patents and trademarks.

- Problem of Measuring Intangible Property

King (1994) noted that, "comparable uncontrolled transactions in intangible property are exceedingly difficult to come by, in part because intangible property is unique to some degree virtually by definition and in part because controlled and uncontrolled intangible licenses tend to differ systematically". King (1994) illustrates this point by comparing related and unrelated party license agreements, finding that a situation involving related parties will more likely entail a parent company licensing 'state-of-the-art' technology to its subsidiary. In an unrelated situation license agreements will tend to involve the lending of more dated technology.

Atkinson and Tyrrall (1997) considered how hard it is to set fair transfer prices for intangible property even when comparable property can be identified. The OECD guidelines suggest that comparability on intangible property should take into account the following factors and their relevance when comparing controlled and uncontrolled transactions:

- a) any limitations on the geographic area in which rights may be exercised;
- b) export restrictions on goods produced;
- c) the exclusive or non-exclusive character of any rights transferred;
- d) the capital investment (to construct new plants or to buy special machines);
- e) the start-up expenses and the development work required in the market;
- f) the possibility of sub-licensing;
- g) the licensee's distribution network; and

h) whether the licensee has the right to participate in further developments of the property by the licensor.

In addition, Atkinson and Tyrall (1997) said that there may be further difficulty in establishing the level of transfer price charged since there is no necessary link between the value of an intangible and the cost of maintaining it. The OECD recommend companies carry out a functional analysis to aid in the breakdown of uncontrolled transactions into component elements (Atkinson and Tyrall, 1997).

- The US and Intangible Property

The introduction of US regulations relating to the transfer of intangible items was, to some extent, a result of the growing number of cases that the IRS were finding of companies transferring high profit margin activities from the US to low tax jurisdictions and charging no royalty for the use of the intangibles developed in the US. According to Halperin and Srinidhi (1996), the results of such activity were returns on assets for the foreign affiliates far in excess of that of the US parent company. Two famous court cases in which the IRS failed to prove companies were undertaking such enterprises were: *Bausch and Lomb Inc. v. Commissioner of Internal Revenue* (92 TC 33 (93)) and *Eli Lilly v. Commissioner of Internal Revenue* (84 TC 996 (85)).

In the case of *Bausch and Lomb*, the US Tax Court had to decide on the appropriateness of a royalty being paid to an affiliate in Ireland, a low tax country, for a license to use valuable intangible property from the US-based parent company. The business involved the manufacture and sale of soft contact lenses and there would have been one or two if any comparable companies, who would not have been using the same processes. Patton (1989)

recorded the conclusion of the case as follows: "The court identified 19 licensing arrangements that could have been used as comparables, yet failed to decide the case based on any of them. Patton (1989) concluded by saying: "If the role of inexact comparables is to be preserved at all for the future...the IRS should provide sufficient guidelines so that taxpayers and courts may make appropriate adjustments when a sufficient number of potentially comparable arrangements exist."

- 1968 Cost-Sharing Provisions

According to King (1994): "The 1968 US regulations sanctioned cost-sharing agreements among members of a controlled a group. These agreements involve the related parties sharing the cost of research and design from the development of the intangibles. The 1968 US regulations required that each parties contribution towards the cost of intangible be in proportion to their expected benefit from the use of the intangible. Each party is then considered a joint owner in the property and does not have to pay any royalties. Similarly, Mawani (1997) pointed out that the OECD guidelines require that any agreements explicitly mention that the expected benefits to each party will be in proportion to the risk sharing and cost contribution.

The 1992 proposed regulations made cost-sharing arrangements more regimented, requiring such dealings to be set out in writing, with appropriate records to back them up and an additional requirement that such intangibles be ultimately developed in the conduct of the trade or business. As well as retaining the 1968 idea that costs and benefits be in proportion to one another, the 1992 regulations insisted that they must be adjusted to depict changes in economic conditions or operations of the business. According to King (1994), cost-sharing

agreements among members of a controlled group are commonplace in a number of research-intensive, high technology industries.

- "Commensurate With Income" Standard

The above cases were partly responsible for Congress passing the US Tax Reform Act of 1986 which, as we have made reference to in previous chapters, added the following to S482 regulations:

"In the case of any transfer (or license) of intangible property ... the income with respect to such transfer (or license) shall be commensurate with the income attributable to the intangible."

In other words, the addition to the S482 regulations requires an affiliate, who uses an intangible developed by an affiliate in another country to pay for the service depending on the amount of benefit they expect to earn from the use of the intangible. This payment is referred to in the regulations as a "superroyalty". Finding generally acceptable measures of such have proved and continue to prove difficult. Governments and taxpayers to a certain extent, do not have access to enough eligible information in order to determine arm's length royalties. In addition, the commensurate with income standard requires periodic adjustments in royalty rates to reflect the actual experience of the parties in utilising the intangible property (Arnold and McIntyre, 1994).

The 1986 US Tax Reform Act, before specifying different acceptable methods, first applied a new perception to the transfer pricing affair called the "arm's length return". According to Halperin and Srinidhi (1996), the underlying principle is that an affiliate may earn the same level of profit per unit as a competitor who does not have the intangible. Durst and Fiamma

(1993) voiced an opinion held by many that this "commensurate with income" standard, with its possibility of IRS (as well as other authorities) second guessing, represents an inappropriate departure from the internationally acceptably arm's length standard. Furthermore, this process departed from traditional beliefs because it was based on returns as opposed to the traditional idea which depended totally on arm's length prices.

The White Paper recognised four methods for pricing inter-company intangibles:

- 1) *exact comparables method* - finding a transfer price by comparison with the same intangible being transferred between unrelated parties in an analogous environment;
- 2) *inexact comparables method* - found from comparing a similar intangible transferred, but not in identical circumstances;
- 3) *arm's length return method* - according to Hufbauer (1992), this method attributes income based on a rate-of-return ratio or on an operating margin such as the so-called Berry ratio; and finally
- 3) *profit split method* - according to Hufbauer (1992), this involves first attributing a portion of income, based on benchmark rates of return, to the manufacturing and marketing activities of affiliated firms, and then assigns the residual income according to the relative value of the intangibles owned by the affiliates.

Halperin and Srinidhi (1996) examined and analysed the difficulties that there may be in the different resource allocations that these methods, compared to the actual arm's length royalty, might cause.

- 1992 US Proposed Regulations

The 1992 US proposed regulations reflected very much what was said in the White Paper although with respect to the transfer pricing of intangibles, the regulations identified and ranked three methodologies:

- i) matching transaction method - looks at the uncontrolled transfer of same intangible under at least very similar circumstances;
- ii) comparable adjustable transaction (CAT) method - looks at an uncontrolled transfer of at least a very similar intangible under different circumstances;
- iii) CPM - compares stated profits of controlled transactions with profits that the controlled transaction would have earned if its profit level indicators had been equivalent to those of uncontrolled parties that perform similar functions (Hufbauer, 1992).

Chapter 3 made reference to the use of CPM acceptable profit ranges. This also applies to CAT and the operating income of the property in question should fall within certain ranges set by the comparable profit interval. Income falling outside an established range could be subject to an IRS adjustment, normally to a position well inside the boundaries.

- 1993 Temporary Regulations

The 1993 temporary regulations introduced a change in preference towards both CPM and CUT. According to Schwartz et al. (1994), CUT is in essence, the CUP method with the important addition that transactions, for the purpose of comparability, must have substantially the same profit potential. They listed the following four points in which CUT, must substantially be the same:

- contract terms, including the exploitation rights granted;
- state of development of the intangible;

- periodic adjustments; and
- uniqueness of the property and the period for which it remains unique.

Unfortunately, the likelihood of finding any useful information regarding comparable uncontrolled transactions will be slight for most taxpayers.

According to Halperin and Srinidhi (1996), "in the case of CUT, regulations implicitly assume that the royalty charged to the independent licensee is not influenced by the requirement that the same royalty must be charged to the affiliate. However, we argue that the royalty charged the independent licensee will be viewed as endogenous by the MNE. When the tax rate in the MNE affiliate's foreign country is less than the tax rate in the US, we have demonstrated that CUT causes the inter-company royalty rate to be lower than the royalty rate under full information. This lower royalty rate results in increased production abroad".

Boatman (1997) pointed out that the application of TNMM is inappropriate since the approach assumes that the company does not own any valuable intangible property. In addition, however, the application of traditional transaction methods such as CUP and resale price method are also difficult, as comparability between controlled and uncontrolled transactions became more difficult to ascertain.

Further to the 1993 temporary regulations recommending the use of either CUT or CPM a third allowable option was introduced, that of an "other" method. According to Schwartz et al. (1994), the three specified methods in this category were as follows:

Residual Allocation Method - profit allocated to balance sheet assets based on the functions performed. Residual intangible profit then allocated based on the relative value of the non-routing intangibles, or on the expenditures related to the development of the intangible.

Capital Employed Allocation Method - available in situations where the level of risk is equal to all parties. The intangible profit is allocated based on the ratio of each entity's capital invested in the relevant activity to the total capital in that activity.

Comparable Profit Split Method - involves identifying comparable companies with similar transactions, functions, product markets, risks and intangibles. It is necessary that all the comparable companies are functionally comparable and that there be reliable financial data.

- **Developments since 1993**

A new act has been introduced in the US in 1997 effecting the transfer of intangible property to foreign corporations or to partnerships. Ryder, Yoder and McGill (1997) reported that now, in general, "if a US shareholder transfers intangible property to a foreign corporation in exchange for stock, the US shareholder is treated as having sold the property to the corporation in exchange for a deemed stream of royalty payments over the useful life of the property". This means that the Act has effectively changed the source of the royalty income from home (US) to foreign. A US taxpayer may now offset any tax on such income against foreign credits.

- **Japan, Germany and the Netherlands**

Throughout this chapter so far we have only really concentrated on the actions of the US and the OECD. In this section we will consider the approaches of the Japanese, Germans and Dutch in attempting to control the pricing of intra-group intangibles. Information has been taken from Price Waterhouse's Worldwide transfer pricing group (1997b) survey which examined these three countries.

- Japan

Under Japanese law intangibles are treated similarly to tangible items. However, Two aspects of 'royalty quantification' are being looked at by the tax authority. These are as follows:

ROYALTY BASE - the basis on which the royalty depends, for example on the sales of intangible property bearing a particular brand name. Price Woodhouse noted, “the potential for relatively objective measurement encouraged Japanese tax authorities to begin their investigation of royalties with a review of the reasonableness of royalty bases.”

ROYALTY RATE - the value of the royalty, for example the rate may change according to the turnover of the licence. Price Waterhouse (1997b) noted, “until the highly publicised 1993 Coca Cola audit, Japanese tax authorities had not seriously challenged royalties. However, it is now common practice when conducting an audit for tax authorities to focus on the royalty base, as well as on royalty rates.”

Price Waterhouse (1997b) said that the authorities are gathering information to establish a database of royalty rates charged by US and European MNEs to their Japanese subsidiaries.

- Germany

According to Price Waterhouse (1997b): "The Administrative Principle states that if a royalty cannot be evaluated in terms of uncontrolled comparables, it is assumed that a conscientious business manager of the licensee would not agree to accept a royalty higher than that which would allow achievement of an appropriate profit from the licensed product(s)."

In addition, the German tax authorities do not accept royalties in return for using a brand name. The only exception where a royalty may be paid is where the trade name is a part of the firm name, but predominantly identified as the trade name.

- The Netherlands

There are no specific requirements with respect to intangible items, taxpayers are left to set transfer prices within the framework of the OECD guidelines. Like reviewing the pricing of tangible property the Netherlands Revenue will examine the expenses incurred by the seller compared to the economic benefits acquired.

- Country Conflicts

As well as looking at individual countries and the way the authorities police the transfer pricing of intangible items, it is also interesting to note the conflicts between tax authorities arising over contradictory opinions on the value of royalties to be paid to related companies across borders. Each country has an opinion on what level of an MNE's global income they feel they have a right to tax. If countries demand for example, that higher royalties should be paid from a company based in another country to the company based within their dominion then this is a form of profit shifting.

Khalaf (1990) made reference to a number of cases of such conflict with companies caught in the middle of revenue maximising authorities. One such example was that of Procter and Gamble and the Spanish and US tax authorities, and in this case a Spanish tax court ordered a royalty be paid on some of the company's products to the US parent, but where the IRS demanded a much higher payment be transferred.

- Hindsight Adjustments

The OECD 1996 update concedes that: "changed facts and circumstances could lead to the revision of conditions of remuneration although the specific reference to periodic adjustments has been removed, and that the transacting parties may reserve the right to make future adjustments."

Boatman (1997) made note of two important implications of this change in view: Firstly, the change in position allowing adjustments contradicts the current position of many European tax authorities; and secondly, this discussion by the OECD may be viewed as a narrowing of conflict between the OECD (allowing hindsight adjustments) and the US Section 482 regulations (allowing periodic adjustments). The point is made, however, that there is no intention to introduce into the OECD guidelines a "commensurate with income" requirement. In any event, the discussion opens the door to hindsight adjustments of intangible property prices, potentially providing tax authorities with a powerful income adjustment weapon (Boatman, 1997).

- Special Considerations for Intragroup Services

Chapter VII of the OECD guidelines considers the transfer of services between associated members of an enterprise. As in line with the already existing guidelines, the update stresses that a service has been rendered only when the activity provides the group member with a benefit that enhances its commercial position and for which it otherwise would have been willing to pay a third party (Boatman, 1997). In addition, however, the report looks at the different potential methodologies that could be used in determining arm's length prices for intangible property. These include cost allocation and apportionment methods.

One of the special considerations is the potential for service transfers at cost. There are some services for which this is acceptable, for example, a supplier whose costs exceed market price, might agree to provide the service to increase its profitability, perhaps by complementing its range of activities. Boatman (1997) pointed out that implicit in this illustration is the idea that the service supplier also engaged in other profitable activities which would bring about a consistency with the final US S482 regulations.

- Need More Research

Halperin and Srinidhi (1996) remarked on the need for more analytical research to understand how the incentives in intangible generation are changed by the regulations.

Halperin and Srinidhi (1996) commented on the need for governments to collect more information on the value of intangibles to decrease the distortion being created in the attempt to set transfer prices. The cost of such data gathering would be costly and obtrusive on the taxpayers involved.

- Conclusion

This chapter has looked at the pace of growth in the area of intangible property and seen the difficulty tax bodies have faced in trying to regulate and recommend structures for transfer pricing. The OECD had expanded and refined its definition of intangible property to help deal with the problem in hand. Difficulties for the authorities appeared most frequently where transactions involved highly valuable intangibles, patents and licenses and a high specialised level of technology.

CHAPTER 5.

TRANSFER PRICING

HARMONISATION

TRANSFER PRICING HARMONISATION

As we have seen in the earlier chapters, the US and OECD have been the main bodies leading the field, specifying the application of ALP in dealing with transfer pricing and developing different methods to cope with the increasing complexities of inter-related transactions. The greatest problem they (and tax authorities worldwide) faced was related to the growth of intangible property (see chapter 4). The US reacted to this growth by introducing the "commensurate with income" standard and the comparable profit method (CPM) in the 1988 White Paper, two ideas which went against the more traditional views held by the rest of the world at that time.

This chapter is concerned with how the OECD and the US have developed their transfer pricing frameworks since the controversial White Paper was presented, to a situation today where the parties have similar opinions on transfer pricing methodologies (TPMs) and their application. The similarities can be seen by comparing the IRS's 1994 final transfer pricing regulations and the OECD's 1995 Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.

CPM and the "Commensurate With Income" Standard

It is generally agreed that some MNEs manipulate their transfer prices to shift their profits to minimise taxes, but the debate is by how much are MNEs avoiding these taxes and what proportion of companies are guilty. The growing accusations by the US tax authorities, that

foreign-owned MNEs in the US, were not paying the same amount of tax that the US-owned MNEs were paying, was the main factor which instigated the introduction of the commensurate with income standard. According to Wartzman (1993), this standard: "Essentially forced companies to check the profits (they) earned from such (inter-related) transactions against an industry average. If their earnings weren't in line, companies were deemed to be establishing their transfer prices incorrectly and could be penalised."

In the US Japanese-owned firms seemed to be at the forefront of the 'accused'. Tadaki (1993) used the following quote from Dianne Kanakis, senior manager at Price Waterhouse in Washington, to illustrate this point: "The IRS will tell you that they're not targeting specifically Japanese companies, but they are targeting sectors. And the industries that they're targeting are dominated by Japanese companies."

Tadaki (1993) said that it would be unlikely that Japanese firms would opt to transfer their profits home since the tax rate there was higher. Furthermore, they might have reasonable explanations for reporting comparably lower reported profits in the US. Yoshio Nakamura, deputy director of the international affairs department at the Federation of Economic Organisations, said: "If the subsidiaries' profit levels are low it may be because Japanese investment in the US is a fairly recent phenomenon that followed the 1985 Plaza Accord, which resulted in the yen's appreciation against the dollar" (Tadaki, 1993).

US-based MNEs appeared afraid of their tax authorities' blatant attack on foreign-owned MNEs. Wartzman (1992) used the following words of Robert Green, vice president of tax policy at the National Foreign Trade Council in Washington, to demonstrate this anxiety, they:

"don't like the US tax collection agency's proposed rules and fear that congressional action could lead America's trading partners to 'scream and shout bloody murder and retaliate'".

Reciprocity is not surprising, according to Otsuka, when you consider, for example, that when the IRS imposes additional taxes on a US subsidiary in relation to the transfer prices between the US subsidiary and its Japanese parent company, the parent is entitled to receive from the Japanese tax authorities a refund of taxes already paid. In the case of Nissan and Toyota, a total of \$769 million was refunded by the Japanese National Tax Administration Agency.

In addition, Khalaf (1990) suggested that attacking foreign firms, in particular Japanese-owned MNEs, was just one step in the broadening of policing on transfer pricing in general and favourable in the American peoples' eyes. As well as foreign tax authorities "getting even" by attacking US-owned firms, the IRS would also gain from concentrating on US owned companies. According to Marrienne Burge, international tax director at Price Waterhouse in the US: "American companies are an easier target, if only because their books are here and written in English. Last year the IRS proposed \$4 billion in income adjustments for American firms to correct improper transfer prices, and only \$500 million for foreign companies" (Khalaf, 1990).

Reed, Holyoke and Harbrecht (1994) reported that PepsiCo Incorporated was one such targeted firm, fighting over an \$880 million bill levied for the period 1985 to 1989 after an extensive audit of their subsidiaries.

1992 OECD Task Force

"Both the OECD and the US endorse ALP, but there has been a need for greater cooperation between countries for some time and in 1992 steps were taken which started a harmonisation process." (Peterson, 1994)

In 1992 the OECD established a task force to review transfer pricing developments in the US. In addition, the realisation of the extent of the differences between the US regulations and the OECD guidelines led to the setting up of another task force in 1993 to revise their own 1979 and 1984 reports. Arnold and McIntyre (1994) said that the OECD had a major 'comprehensive and fundamental' alteration in mind. Elliott (1995) said that the task forces' objectives were: "To develop clearer guidelines for the application of the arm's length principle ... acceptable to taxpayers and tax authorities and thereby minimise conflict ... should provide a clearer indication of what methods are acceptable and which are not and under what circumstances a particular method could be appropriately applied."

Both the OECD and US had looked to external sources for help with their transfer pricing programmes. As a result, for example, the US tried to incorporate the observations of many of its treaty partners and the OECD had consulted the Business and Industry Advisory Committee (BIAC).

Draft Part I of the new OECD guidelines was issued in July 1994 for public comment at the same time as US Treasury published its final Section 482 regulations. John Fairley (in "Transfer Pricing Will Have Major Effect", 1994b), Head of Ernst and Young's London-based International Tax Group in 1994, said that "It is perhaps not surprising that the OECD report

was published one week after the US Internal Revenue Service released its final regulations. There is some similarity between the approaches being adopted." The new regulations and guidelines exhibited a lot of progress towards the global treatment of transfer pricing, taking similar positions on key issues. Immediate similarities between the two documents demonstrates some measure of liaison between the two sets of legislators and an attempt to reach a satisfactory and workable consensus (Elliott, 1995).

Best Method Rule

Wartzman (1993) said that, "the thrust of the regulations is to give companies more flexibility in choosing which pricing method to use". This can be seen with the adoption of the "best method" rule. The rule requires that the arm's length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result. Thus, according to Section 482, there is no strict priority of methods, and no method will invariably be considered to be more reliable than others.

The US 1993 temporary regulations list several factors to aid in the best method selection process. They include:

- i) the completeness and accuracy of the data used to determine the method;
- ii) the degree of comparability between controlled and uncontrolled transactions; and
- iii) (if adjustments are made to increase the degree of comparability) the number, magnitude, and accuracy of the adjustments required to select the method.

The US 1994 final regulations noted that the reliability of the assumptions on which the methods are founded and the sensitivity of results to these assumptions are also important considerations.

Ogum and Kim (1995) noted that: "the best method rule should not be controversial if the following conditions apply: the selection of a method is made in good faith; it is properly documented; and the result produced by the method is reasonable." The IRS, however, can question a taxpayers choice and select a different method if it is subsequently shown to produce a more reliable measure. Ogum and Kim (1995) found that, "rather than limiting transfer pricing disputes, the (best method) role of the temporary regulations can create a new controversy". Reviewing all the transfer pricing methods would require more time and effort for MNEs than otherwise. Ogum and Kim (1995) said that this review could involve hiring a number of tax and economic professionals, thereby increasing the cost of compliance. In addition, there would be no guarantee that tax officials, other than those in the US, would accept the eventual method chosen.

The OECD demonstrates a greater preference than the US for taxpayers to use traditional transactional TPMs when possible. However, similarly to the US, the OECD does not have a strict hierarchy of TPMs. The OECD fosters a similar principle to the best method rule, identifying that: "No one method is suitable in every possible situation", and additionally, that "the applicability need not be disproved." The last part of the above sentence is different to the US final regulations because the OECD recommends that tax authorities should not dispute a taxpayers choice of method if it is proved, through documentation, that the use adheres to the ALP. The IRS are much more likely to question the use of a particular TPM in preference to the other available methods. The OECD guidelines say that: "While in some

cases the choice of a method may not be straightforward and more than one method may initially considered, generally it will be possible to select one method that is apt to provide the best estimation of an arm's length price."

The idea of using a method which gives the "best" estimate and the introduction of the "best" method rule represent progress towards the harmonisation of opinions. This is particularly obvious when comparing this rule with earlier reports which were more concerned that the taxpayer use one of the traditional methods above all else if at all possible rather than for the reason that it produced the most acceptable results.

Change in the View of CPM

A compromise has almost been reached in the approaches of the US and OECD towards CPM (Elliott, 1995). The US has decreased the importance of CPM as a transfer pricing method, and in turn, the OECD has admitted that CPM may have some use in exceptional circumstances and can be employed as a last result. Although the change in opinions is beneficial to international transfer pricing harmonisation, the US rules still appear to give CPM higher priority.

The introduction of the transactional net margin method (TNMM) by the OECD demonstrated a greater acceptance of the profit-based methods. This is good for both tax authorities and taxpayers alike since it demonstrates an understanding that profit-based methods appear the most suitable options in an increasing number of cases. The OECD's support for profit-based methods should and appears to have helped persuade tax authorities to see the positive aspects

of using of them (in the absence of more suitable alternatives) in the face of arguments over whether they are arm's length methods or not.

TNMM, as noted in Chapter 3, is accused of being the OECD's version of CPM and that conceptually, they are the same method. The differences between the two lies in the nuances of their application, particularly the IRS emphasis on the inter quartile range and adjustment to the midpoint (Wright et al, 1995). One difference worth drawing attention to is that CPM was introduced to deal with the problems of transfer pricing of intangibles whereas TNMM is not primarily for this purpose since the approach assumes that the tested entity does not own valuable intangible assets (Boatman, 1997). OECD did not embrace CPM directly because of the alien format it was written in (not in a generally accepted OECD format), which, according to Jonsson (1998), was not liked by fiscal governments when CPM first appeared in Europe. In addition, the OECD changed the form of CPM because of complaints from the BIAC, that CPM did not represent an arm's length method. There is substantial resistance to CPM by the rest of the world community, for example, it is not UK policy to accept CPM (Hickman, 1998). The OECD and US, however, have made a significant step towards international consensus by restricting the use of CPM and by introducing and restricting the use of the OECD equivalent, TNMM.

As far as the future of these two profit-based methods are concerned, over time it could be that they adapt so much they become the same method. Whether it is TNMM or CPM which is compromised the most depends on a number of factors. For example, how well countries and taxpayers lead by the OECD guidelines take to TNMM, particularly those most adverse to this almost 'American-influenced' method, and the readiness to accept an adaption of this method. It may be the case that as more and more tax authorities experience troubles with the

application of traditional transactional methods on complex transactions they will recognise the need for profit-based methods in transfer pricing methods. Everyone realises the limitations of the arm's length pricing methods and a change in TNMM and/or CPM to apply to an increasing number of 'difficult' transactions can only help tax authorities, as long as these changes are reasonable and understood.

Non-Arm's Length Methods

The initial introduction of CPM, a method viewed by many as not based on the arm's length principle, worried many observers outside the US that the IRS would instigate additional methods straying further away from the internationally accepted arm's length standard. For example, tax authorities and taxpayers were afraid that the US would allow any global formulary apportionment (GFA) methods in the future (because it does not adhere to ALP). The decrease in preference over the use of CPM has helped, however, to quench some of those fears.

The OECD continues to support use of the ALP uniquely (although some question that the TNMM and the profit split method is an arm's length method). The 1995 guidelines specifically repudiated the use of a GFA method. Described by OECD (1995), GFA: "Allocates the global profits of an MNE group on a consolidated basis among the associated enterprises in different countries on the basis of a predetermined formula."

Stitt (1995) criticises GFA methods as not being able to provide answers to transfer pricing problems in theory or in practice. His concern is based on a recognition that: "Politicians in

certain countries still see formulary apportionments as a relatively easy way to increase their country's tax take, the practical difficulties either of establishing universally acceptable formulae or of accepting that double taxation will arise are conveniently forgotten!"

No matter how bad the arm's length pricing system is with all its faults, it is the only system which stands a chance of working. A majority of governments worldwide have incorporated the ALP into their transfer pricing legislation (see Chapter 6) and of the remaining governments, a high percentage will probably over the next five to ten years, introduce a system based on this principle. The ALP is an idea accepted worldwide as a way to control transfer pricing and there is an absence of suitable alternatives which would not stand a chance of receiving the same level of support. The ALP was first introduced in 1935 in the US and it is still being introduced by countries today. An alternative approach risks not being accepted and then if it is accepted, a long time over which different governments would replace ALP with it (especially if it compares to the time frame for introduction of ALP as seen above). If countries tried to change from ALP to an alternative method they could expect to face an onslaught of double taxation problems for firms with cross-border transactions involving their country. How would that problem be solved if one country adheres to the ALP and the other to the new method? Who would admit to being wrong?

European tax harmonisation might help reduce some of the problems of international transfer pricing manipulation faced by governments. Business between Europe and other continents would then be the major concern of tax authorities and attract all the attention. This would mean increased attention on transactions from European countries to those with lower tax rates or transactions from high tax countries to European countries. The policing of transfer pricing would become an easier task on the whole.

Comparability

Both the guidelines and Section 482 regulations provide similar standards for comparability analysis of independent transactions and both emphasise the need for functional analysis, an acceptable range of results and the use of multiple year data:

- Functional Analysis

The guidelines appear to pay particular attention to functional analysis. OECD (1995) points out that: "The functions carried out (taking into account the assets used and the risks assumed) will determine to some extent the allocation of risks between the parties, and therefore the conditions each party would expect in arm's length dealings."

Section 482 lists the following relevant risks:

- (i) market risks, including fluctuations in cost, demand, pricing, and inventory levels;
- (ii) risks associated with the success or failure of research and development activities;
- (iii) financial risks, including fluctuations in foreign currency rates of exchange and interest rates;
- (iv) credit and collection risks;
- (v) product liability risks; and
- (vi) general business risks related to the ownership of property, plant, and equipment.

- Contractual Terms

The terms of contracts, according to OECD (1995), "generally define explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the parties. OECD

(1995) says that the analysis of contractual terms should be included as part of the functional analysis above.

Section 482 noted that the terms of contracts which should be considered include:

- (1) the form of consideration charged or paid;
- (2) sales or purchase volume;
- (3) the scope and terms of warranties provided;
- (4) rights to updates, revisions or modifications;
- (5) the duration of the agreement and termination and renegotiating rights;
- (6) collateral transactions or ongoing business relationships between the buyer and seller; and
- (7) extension of credit and payment terms.

- Economic Circumstances

Factors outside a company's control may effect the prices of identical goods and services across boundaries. These 'economic' circumstances need consideration to achieve better comparability amongst firms. Considering the market of a good or service is one step which a MNE should take and the factors listed by OECD (1995) effecting the market include the geographical location; size of the markets; extent of the competition and the relative competitive positions of the buyers and sellers; the availability of substitute goods and services; the levels of supply and demand in the market to name a few.

- Business Strategies

According to OECD (1995), "business strategies would take into account many aspects of an enterprise, such as innovation and new product development, degree of diversification, risk aversion, assessment of political changes, input of existing and planned labour laws" and so

on. These business strategies are considered as a valid reason for having results that would otherwise not be considered arm's length (Schwartz et al, 1995).

According to Stitt (1995), who recognised the importance of comparability analysis, the guidelines say that it is crucial: "For tax authorities to recognise actual transactions and the way they are structured: they should not attempt to substitute other transactions for them."

Stitt (1995) listed the only two exceptions to that rule which exist:

F if economic substance differs from the form; or

F if the arrangements made in relation to the transaction, viewed in their totality, differ from those that would have been adopted by independent enterprises behaving in a commercially rational manner, and the actual structure practically impedes the tax administration from determining an appropriate transfer price.

Section 482 notes the following functions that may need to be accounted for in determining the comparability of two transactions:

- (a) research and development;
- (b) product design and engineering;
- (c) manufacturing, production and process engineering;
- (d) product fabrication, extraction, and assembly;
- (e) purchasing and materials management;
- (f) marketing and distribution functions, including inventory management, warranty administration, and advertising activities;
- (g) transportation and warehousing; and
- (h) managerial, legal, accounting and finance, credit and collection, training, and personnel management services.

The OECD (1995) and the US (1994) permit the use of inexact comparables similar to the controlled transaction under revision. According to Schwartz et al (1995), "they differ only in their evaluation of the probability that comparable uncontrolled transactions can be identified and that adequate and reliable data can be obtained".

In addition to carrying out analysis for single transactions the OECD (1995) noted that this may not be possible in some situations and that where transactions are closely associated then it should be acceptable for those transactions to be looked at together. Stitt (1995) noted that this is already common practice in a number of countries.

Comparability exercises are problematic and limited when the products involved are unique (for example new and/or patented) and when the products are intangible or involve intangible aspects. A taxpayer needs to find the closest possible independent comparable and make any adjustments necessary to account for any differences between the two. Unfortunately, it can be argued what a realistic adjustment might be? This is a decision which will be based largely on judgement and, therefore, open to criticism and contradicting opinions. Here is where the problem lies and where a huge database of all the comparable goods and services would go some way to aid the taxpayer in supporting the choice of transfer price. Whether this is actually feasible is another question. The act of comparing products to one another is a good, solid way to prove transfer prices are at arm's length. The larger and more complete the databases of comparables are the greater the possibility of finding the most comparable product, and the smaller the resultant adjustments required. This is the case even with intangibles and unique products, the only thing which will help taxpayers support their transfer prices is to end up with a comparable product which is as similar as possible. A number of institutions, including top accountancy firms such as KPMG, are working on, or

have already compiled, a database of comparables, or the addresses of the databases relevant to different types of products. Deloitte Touche Tohmatsu International (1998c), for example, said: "Our proprietary software searches a number of computerised databases for all companies appearing in chosen Standard Industrial Classification Codes. Since classifications vary by database, the multi-database search ensures the most complete list of companies worldwide engaging in transactions comparable to those being tested." The area of comparability analysis is an area of big business for accountancy firms and an expensive process for MNEs for whom this information is necessary to support the use of any transfer price.

Arm's Length Range

Both the OECD (1995) and US (1994) accept that in a majority of cases there will not be one correct transfer price for an individual transaction and that there will probably be a range of acceptable prices. The range of results, conforming with the US regulations and OECD guidelines, is determined either from applying the same TPM to multiple comparable data or from applying different TPMs to a transaction. Section 482 notes the following: "The arm's length range will be derived only from those uncontrolled comparables that have, or through adjustments can be brought to, a similar level of comparability and reliability, and uncontrolled comparables that have a significantly lower level of comparability and reliability will not be used in establishing the arm's length range."

The OECD (1995) noted that, "because transfer pricing is not an exact science, there will be many occasions when the application of the most appropriate method or methods produces a range of figures all of which are relatively equally reliable".

On occasions when a taxpayer ends up with results outside the range in the case of the US, it is likely that the profit reported would be moved forcibly to within the acceptable range, typically to the midpoint. In the case of the OECD, the guidelines recommend that the taxpayer be allowed the opportunity to prove that a transaction was carried out at arm's length, regardless that the profit recorded was outside the predetermined boundaries. In the case where the taxpayer is unable to justify their results the guidelines say that, "the tax administration must determine how to adjust the conditions of the controlled transaction taking into account the arm's length range". The OECD advocates that a movement should be done depending on the facts and circumstances of the case. In some cases the most acceptable answer will be to move the profit to the middle, as the IRS would.

On the whole the use of arm's length ranges could be taken a step further, to help reduce the work necessary for taxpayer's to prove the transfer price they choose is at arm's length. By creating an acceptable range of profits which could be reported, the taxpayer would not have to specify a transfer price and go to all the lengths to justify it if the results were (well) within that predetermined range. It would be necessary for the boundaries (of the range) to be checked on a regular basis against comparable transactions to make sure they still represented an arm's length "area".

Multiple Year Data

"In order to obtain a complete understanding of the facts and circumstances surrounding the controlled transaction, it might be useful to examine data from both the year under examination and prior years" (OECD, 1995). Section 482 said that the circumstances in which it may be preferable to look at multiple year data include looking to discover the extent to which complete and accurate data is available for the taxable year under review, the effect of the business cycles in the controlled taxpayer's industry, or the effects of life cycles of the product being examined. OECD (1995) suggests that this data might be worthwhile where a taxpayer has resorted to using a transactional profit method.

Section 482 noted the following use of multiple year data: "It may be considered to determine whether the same economic conditions that caused the controlled taxpayer's results had a comparable effect over a comparable period of time on the uncontrolled comparables that establish the arm's length range."

Periodic Adjustments

From Arnold and McIntyre (1994): "Several parts of the 1995 OECD report offer a cautious endorsement of the principles contained in the 1994 US section 482 regulations. In limited circumstances, for example, the US regulations provide for periodic adjustments to the royalty rates paid with respect to transfers of valuable intangible property. The report accepts some periodic adjustments as being consistent with the arm's length standard, but it suggests that tax administrations should make such adjustments only in certain exceptional cases."

Penalties and Documentation

Perfect information would be the answer to transfer pricing. Firms could look at all the data on comparable firms and comparable transactions and be able to set arm's length transfer prices without any of the current troubles experienced and tax authorities could easily see that they were adhering to the ALP. Companies and tax authorities alike, however, would totally condone the idea, it would kill market competitiveness dead. What then is the next best alternative? Countries are doing what they can to obtain as much information as possible on firms. This is aided and led by the actions of the OECD and US.

The OECD and US agree that it is necessary to have "appropriate" documentation from firms, on their transfer pricing policies, and to have some system of retribution for deviating away from the acceptable. The final US regulations have not relieved the taxpayer of 'contemporaneous' documentation required under Section 6662(e) to avoid the risk of US transfer pricing penalties (Farrell, 1991). The guidelines, however, offer a more cautious endorsement of this dual strategy, advising that member countries penalise in a way which is fair, and not unduly onerous for taxpayers. This may be true, comparatively, but on the part of taxpayers, it appears that fears about the ever-increasing costs of tax compliance have been insufficiently recognised (Stitt, 1995).

- Documentation

Sherwood (1997) said that: "For companies with an extensive number of related-party transactions in many categories (eg. tangibles, intangibles, services etc.) the issue has been whether to document all transactions or only those most likely to undergo the most scrutiny." In addition, as companies have been increasing the level of documentation they prepare, so tax

authorities worldwide have increased the number of examinations they carry out. Only by looking at the US, the OECD and other tax authorities' regulations and what they expect the amount and level of detail to be, and hence the cost, can an individual taxpayer decide the amount of documentation they are prepared to create and maintain.

In the US, the increased burden of documentation is the downfall of the newer more flexible regulations. Murray Schlussel (Zach, 1993), a senior tax advisor with Ford Motors, in response to the question what do tax authorities think of as the purpose for existing businesses said: "To make money or to do tax returns?"

The OECD (1995) guidelines devoted a whole chapter to the issue of documentation and an example of the organisation's denial about the real cost to taxpayers. This is demonstrated in the following passage taken from Chapter V, paragraph 5.6:

"In considering whether transfer pricing is appropriate for tax purposes, it may be necessary in applying principles of prudent business management for the taxpayer to prepare or refer to written materials that would not otherwise be prepared or referred to in the absence of tax considerations, including documents from foreign associated enterprises."

In response to this, Self (1994) said: "Surely, if a document would not be necessary in a third party transaction there should be no need to create it in an intra-group situation."

On the other hand Chapter V of the OECD guidelines did state that:

"The taxpayer should not be expected to incur disproportionately high costs and burdens to obtain documents from foreign associated enterprises or to engage in an exhaustive search for comparable data from uncontrolled transactions if the

taxpayer reasonably believes, having regard to the principles of this Report, either that no comparable data exists or that the cost of locating the comparable data would be disproportionately high relative to the amounts at issue."

The fact that OECD (1995) said tax administrations must make rulings on related transactions, whether they are furnished with complete information or not, means that it might be beneficial to a taxpayer to supply as thorough documentation as possible to, "improve the persuasiveness of its approach to transfer pricing".

OECD (1995a), however, recognised a number of problems for taxpayers collecting information on foreign associated parties:

"When the taxpayer is a subsidiary of a foreign associated enterprise or is only a minority shareholder, information may be difficult to obtain because the taxpayer does not have control of the associated enterprise. In any case, accounting standards and legal documentation requirements (and the language they are written in) differ from country to country."

Chapter V in the guidelines ended by stating that the Committee on Fiscal Affairs (OECD, 1995) intends to study the issue of documentation further to develop additional guidance that might be given to assist taxpayers and tax administrations in this area.

- Transfer Pricing Penalties

The issue of penalties was mentioned at the beginning of this section as something which the US uses as a tool with which to control their taxpayers and something which the OECD recommends only in the cases of blatant exploitation of transfer prices. Penalties were introduced to encourage taxpayers to maintain acceptable levels of documentation on the

transfer prices of interrelated transactions. According to Sherwood (1997): "To avoid penalties, a company must maintain sufficient documentation to establish that the taxpayer reasonably concluded that given the available data and the applicable pricing methods, the (chosen) method provides the most reliable measure of an arm's length result under the principle of the best method rule in Reg. 1.482-1(c) (Section 482 regulations)."

The OECD does not offer a framework recommending how penalties should (or should not) be administered. A framework might be beneficial, however, because a report published by Ernst and Young showed that 400 MNEs "urged OECD countries to adopt a more consistent approach to enforcement measures and policing arrangements" (Adams, 1997).

As there is no structure for penalties in the guidelines, the end of this section will, therefore, be concerned for the large part with the development of a penalty regime in the US and the steps which the regulations state must be taken to avoid them.

The first accuracy-related penalties were introduced in the 1990 US Revenue Reconciliation Act. The result was that Section 6662(e) of the Internal Revenue Code provided for the administration of penalties on tax years ending after November 5, 1990 (Durst and Fiamma, 1993). Smith (1998) noted that for taxable years after 1993, most taxpayers with Section 482 controlled transactions will potentially be subject to the penalties.

The two standard penalties dispensed were 20% and 40% of the resulting tax deficiency depending on the severity of the situation:

A penalty of 20% is applied in cases of substantial valuation misstatements. According to Farrell (1991) this is when

- the price of any intercompany item claimed on the tax return (i.e., the amount of purchase price, fees for services, royalties, interest or rents) is 200% or more (or 50% or less) of the amount determined under Section 482 to be the correct amount for such item (transactional penalty); or
- the net Section 482 transfer price adjustments for the tax year exceed \$10 million (net adjustment penalty).

The penalty is 40% of the tax deficiency, in cases of gross valuation misstatements, when the additional income attributable to transfer price adjustments exceeds \$20 million (or the price on the tax return is 400% or more or 25% or less of the amount determined as correct).

An example of a country which has followed the US's lead and introduced penalties is Japan. Here a taxpayer will automatically be penalised by 10% for any underpayment of tax. Yoost and Miyajima (1997) noted this penalty will increase to 15% in cases of large assessments and to 35% in cases of fraud or concealment. In addition, Canada has introduced 10% penalties when a taxpayer can be shown not to have made reasonable efforts to determine and use arm's length transfer prices (Will, 1998 and Price Waterhouse, 1997). This would be the case, according to Mawani (1997), when the total adjustments of a taxpayer exceeds the lesser of: 10% of their gross revenues; and \$5,000,000.

It might be the case in the future, with the willingness of tax authorities to adopt a similar system of penalties as the US, that the OECD guidelines would have to accept and incorporate the opinions of these tax authorities as opposed to the usual pattern of the tax authorities following the recommendations of the OECD. The OECD might have change its views on

penalties and instead of tentatively approving the use of them, creating a framework for fining taxpayers (they could follow the US, for example, and have 20% and 40% penalties).

- Avoidance of Transfer Pricing Penalties

Smith (1998) noted, with regards to the application of penalties to relatively small taxpayers in the US, the attitude of Carol Carter, manager of the group of international and financial products examiners recently established in Seattle: "A good faith internal attempt to show how transfer prices were set will go a long way with her and her international examiners. The size and sophistication of the taxpayer will be taken into account in evaluating compliance with Section 6662(e).

According to Smith (1998) a taxpayer can avoid transactional and net adjustment penalties by doing two things: (1) selecting and applying (in a "reasonable" manner) a transfer pricing methodology; and (2) contemporaneously documenting the selection and application process.

A penalty can only be avoided on a non-arm's length transfer price if the taxpayer can demonstrate "reasonable cause" and "good faith" exceptions in setting transfer prices. Smith (1998) listed some of the relevant factors listed in the regulations which would indicate methods selected in a "reasonable manner":

- “ The experience and knowledge of the taxpayer, including all members of the taxpayer's controlled group.
- “ The extent to which reliable data was available and the data was analysed in a reasonable manner.
- “ The extent to which the taxpayer followed the relevant requirements set forth in regulations under section 482 with respect to the application of the method.

“ The extent to which the taxpayer reasonably relied on a study or other analysis performed by a professional qualified to conduct such a study or analysis, including an attorney, accountant, or economist.

“ If the taxpayer attempted to determine an arm's length result by using more than one uncontrolled comparable, whether the taxpayer arbitrarily selected a result that corresponds to an extreme point in the range of results derived from the uncontrolled comparables.

“The extent to which the taxpayer relied on a transfer pricing methodology developed and applied pursuant to an Advance Pricing Agreement for a prior taxable year, or specifically approved by the Internal Revenue Service pursuant to a transfer pricing audit of the transactions at issue for a prior taxable year, provided that the taxpayer applied the approved method reasonably and consistently with its prior application, and the facts and circumstances surrounding the use of the method have not materially changed since the time of the IRS's action, or if the facts and circumstances have changed in a way that materially affects the reliability of the results, the taxpayer makes appropriate adjustments to reflect such changes.

“ The size of a net transfer pricing adjustment in relation to the size of the controlled transaction out of which the adjustment arose.

Farrell (1991) said that, "various precedents under the "reasonable cause" exception have excused those taxpayers who have demonstrated that they took "ordinary business care" in dealing with their tax affairs from penalties. This, however, necessitates an appropriate level of documentation. The following is a list, from section 6662, of the primary documents which should be produced in order to avoid penalties:

- An overview of the taxpayer's business;
- A description of the taxpayer's organisational structure;
- Any documentation explicitly required by the regulations under section 482;

- A description of the method selected and an explanation of why that method was selected;
- A description of the alternative methods and an explanation of why they were not selected;
- A description of the controlled transaction and any internal data used to analyse those transactions;
- A description of the comparables that were used, how comparability was evaluated, and what adjustments were made;
- An explanation of the economic analysis and projections relied upon in developing the method;
- A description or summary of any relevant data that the taxpayer obtains after the end of the tax year and before filing a tax return, which would help determine if a taxpayer selected and applied a specified method in a reasonable manner; and
- A general index of the principal and background documents and a description of the recordkeeping system used for cataloguing and accessing those documents. (Skantz, 1998)

Smith (1998) ended his article by noting that not every document listed would be necessary in determining the transfer pricing methodologies (TPMs), depending on the taxpayer's individual facts and circumstances. In addition, a number of specific documents not mentioned in the regulations might be essential to a taxpayer to demonstrate correct selection and use of a particular TPM.

The use of penalties has brought an onslaught of criticism from MNEs, Pierre Solal, corporate tax director at Alcatel said: "As a time when multinationals must improve productivity to survive, reduce fixed costs and overheads and constantly adopt to a fast changing environment, tax authorities around the world should punish those responsible for obvious

abuses. They should not use the tax code to penalise struggling economic actors" (Sayer, 1995).

Further Harmonisation?

There appears to have been some degree of communication between the US and OECD from looking at the regulations and guidelines. According to Elliott (1995): "The immediate similarities between the two documents demonstrate some measure of liaison between the two sets of legislators and an attempt to reach a satisfactory and workable consensus." Schwartz et al (1995) concluded the following about the OECD and US: "Both endorsed ALP and rejected the unitary approach...both recognise the difficulty in finding CUPs and provide for appropriate adjustments. Both emphasise the need for functional analysis to determine comparability and allow for a range of results and the use of multiple year data."

With the new, generally consistent OECD (1995) and US (1995) reports, differences exist in only a few cases. US taxpayers who comply with Section 482 regulations should not be exposed to a significant risk of double taxation in OECD member countries (Greenhill and Bee, 1996).

Progress Since OECD 1995 Guidelines

Since there is more information on the advancements of the guidelines since 1995, this section will concentrate on the work of the OECD. The OECD has issued updates to the 1995

guidelines in the form of more chapters. In April 1996 Chapter VI broached the transfer of intangible property and Chapter VII discussed the transfer of services. In addition, Chapter VIII, the last chapter to be added, was released in October 1997 and is concerned with cost contribution arrangements (CCA). According to OECD (1997), a common example is a CCA for the joint development of intangible property where each participant obtains a share of rights in the developed property. In summary, the chapter says that to apply the arm's length principle a participant must give a value equal to that which an independent company would have assigned in comparable circumstances. The participant's proportionate share of total contributions will be consistent with the share of prospective benefits.

OECD (1997) noted that they were going to concentrate on four particular areas:

- “ More detailed worked examples of the five approved methods of applying the guidelines will be issued to assist taxpayers.
- “ The general principles of the guidelines may be difficult to use in complex situations, such as permanent establishments and thin capitalisation.
- “ The implementation of the guidelines and the design of administrative procedures are being re-examined to look for improvements. For example, should the OECD establish a procedure for advance transfer pricing arrangements? Is there a need for OECD-wide arbitration? Can greater consistency between the valuation of transactions for income tax and customs duties be achieved?
- “ Compiling the core chapters for paperback release.

In 1998 the OECD issued a further update in the form of two new annexes and a revised glossary to the 1995 guidelines. The first addition was a set of guidelines for monitoring procedures on the guidelines and the involvement of the business community. OECD (1998)

says that the objective of the monitoring process: "Is to examine how far Member countries' legislation, regulations and administrative practices are consistent with the guidelines and to identify areas where the guidelines may require further explanation, amendments or additions." OECD (1998) highlights the four main parts to the monitoring process:

- a) *Peer Reviews*: Aims to gain detailed information on legislation, practices and experiences of transfer pricing in Member countries. The first level would be an "issue review", which would look at the approach taken by all Member countries to a particular issue of widespread significance. The second level would be a "limited review" which would only look at the approach of a particular country or countries in relation to a specific issue. The third level would be a "full review" of a particular country which would address directly the interpretation and application of the Guidelines in the particular Member country.
- b) *Identification and Analysis of Difficult Case Paradigms*: Identify and analyse difficult fact patterns and problem areas which present obstacles to an internationally consistent application of the TPMs set out in the Guidelines. This will also include areas where the Guidelines currently appear to offer no or insufficient guidance.
- c) *Updates of Legislation and Practice*: The Secretariat will solicit from Member countries reports on developments in their domestic transfer pricing legislation, regulations, and administrative practices, consistent with the invitation of the Council.
- d) *Developments of Examples*: The examples are not intended to develop new principles or to cover new issues but rather to assist in interpreting principles and in addressing difficult issues already discussed in the Guidelines.

The second annex of the update provided examples to illustrate the transfer pricing guidelines and the glossary had been updated to include terms introduced in chapters VI to VIII.

Conclusion

There has been a definite harmonisation of views towards transfer pricing of the OECD and the US. This is evidenced, for example, through the introduction of the similar "best" estimate and "best" method rule, acceptance of CPM and introduction of TNMM, the similar standards for comparability, and the use of arm's length ranges and multiple year data. There is some difference in the documentation requirements, the US demanding more contemporaneous data, and there is more enthusiasm for penalties on the part of the US. Further harmonisation could take place and this would probably result in almost identical approaches to transfer pricing control.

INFLUENCE OF THE OECD AND US
PART A
A TIMELINE OF TRANSFER PRICING LEGISLATION

The previous chapter looked at the developments and gradual harmonisation of the US and OECD in international transfer pricing. Their approaches have affected and continue to affect the approaches of other countries worldwide. This chapter is presented as a timeline of events from pre-sixties to late 1990's. In general, it illustrates that the US has pioneered approaches for controlling international transfer pricing, the OECD has reacted to those approaches by producing guidelines and the rest of the world has followed whatever the OECD has suggested. (The most important years for the US and OECD are in bold below)

Pre-Sixties

Very little international trade, transfer pricing almost wholly concerned with transfer pricing on a local scale. Companies transferring goods internally across states, with their different tax rates, in the US is the closest to cross-border transactions.

- 1921

US took first legislative action against tax avoidance through use of tax havens.

- **1928**

The above was followed shortly with the passing of the Revenue Act, which increased the power of the IRS to prevent tax manipulation.

- **1932**

The League of Nations carried out a detailed study of the taxation of MNEs. The studies were written by national experts and co-ordinated by Michael B Carroll, the US representative on the League's Fiscal Committee. Carroll's analytical report identified the problem of "transfer pricing", probably the first time, as one of the key issues posed for national regulators by the internationalisation of business organisations (Picciotto, 1992).

- **1935**

Fundamental year - issue of US S482 regulations introducing ALP. Not used on a international basis much at this time.

- **1954**

S482 formally introduced into Internal Revenue Code.

- **1957**

Germany introduced control of transfer pricing into S22 of Act Against Restraints of Competition.

Sixties

A second decade dominated by US actions.

- 1962

Brazil also took heed and encompassed transfer pricing control in Law Number 4137.

In this same year the US abolished the deferral privilege with respect to the profits of tax haven subsidiaries, which according to Plasschaert (1994): "Has proven quite effective in thwarting the tax haven escape channel."

- 1964

Individual Income Tax Act passed in the Netherlands. Article 9 regulated according to the following presupposition that: the business profits of a given year must be computed according to sound business practice, applied with consistency and without regard to the probable tax consequences. Cases of departure from this were dealt with according to the individual facts by local tax officials.

- 1968

The US introduced the three transaction methods (CUP, resale price and cost plus) into Section 482 regulations in a strict hierarchy of preference (CUP first). The IRS given authority to assert appropriate arm's length price on companies.

At the same time, the US began a campaign to draw worldwide attention to the ALP willing everyone to adhere to it.

Seventies

This decade demonstrates how successful the US were in their campaign. A large number of countries were quick to incorporate ALP methods into legislation. Emerging international trade among related companies and differing national tax rates signalled the inception of double taxation.

- 1970

Pakistan is one example of a country made aware of transfer pricing manipulations through US crusade and embodied control in Monopolies and Restrictive Trade Practices Ordinance Number V.

- 1975

Tax treaties could be seen as one solution to double taxation, the UK and US, two stable and respected countries, signed one in this year.

- 1976

Another solution came with the ECC "proposal for a Council Directive on the Elimination of Double Taxation in Connection with the adjustment of transfers of profit between associated enterprises" (Arbitration Procedure). The problem addressed through the provision of arbitration facilities, a means through which any disagreements arising between MNEs and governments could be submitted for review.

- 1977

A way that governments can better understand MNEs is through a greater supply of information on them. In 1977 the EEC Directive provided for the exchange and share of data between governments.

- 1979

After the attempts of US to encourage ALP acceptance, the second main party in the transfer pricing ring, the OECD, enshrined in Article 9 on the 1979 OECD Model Taxation Convention on Income and on Capital this same principle and favouring the same transaction methods.

The published guidelines also followed the EEC 1976 Directive addressing double taxation matters and as a result became the "accepted blueprint for subsequent double tax treaties (DTTs) between different nations.

Eighties

This was a period of further worldwide recognition of international transfer pricing, particularly after the publishing of 1979 OECD guidelines, which reaffirmed the US's approach, and some refinement of existing legislation.

- 1982

Australia issued Division 13 of Income Tax Assessment Act, containing recommendations to the Commissioner of Taxation as to ways in which the transfer pricing provisions are

applicable. No mention of specific methods suggested, surprising considering OECD and US pronouncements.

- 1983

Germany regulates transfer pricing through three provisions of corporate tax law: the ALP; hidden profit distributions and hidden capital distributions. In 1983, according to Borstell et al (1997): "As an interpretation of these three provisions the tax authorities issued a Statement on the Principles Governing the Examination of Income Allocation Between Internationally Related Companies - the so-called Administrative Principles. The purpose of the Administrative Principles is to provide a directive concerning the tax audit treatment of transfer pricing cases and to ensure the uniform application of rules and methods within the fiscal services."

- 1984

Netherlands have been one of the most independent countries in development of transfer pricing supervision. In 1984 a group of local tax officials published a booklet on the treatment of transfer pricing disputes and common practice. This became identified as the standard rulings. A year later these ruling were incorporated into a paper released by the Ministry of Finance on cost resolution. The paper also showed support for the 1979 and 1984 OECD guidelines.

The OECD published more guidelines, "Transfer Pricing and Multinational Enterprises: Three Related Issues". This paper concerned itself with the mutual agreement procedure, and banking, and the allocation of central management and service costs.

- 1986

Japan introduced legislation of intercompany pricing, based on OECD guidelines, in Article 66.5 of Special Taxation Measures Law and in Special Taxation Law relating to a Tax Treaty. Borstell et al (1997) noted the following about Japan: "Since the introduction of the transfer pricing legal framework in 1986, the tax authorities have become very aggressive in monitoring cross-border transactions. Over ten years there have been 130 transfer pricing cases which have resulted in tax adjustments generating income of \$1.54 billion". These cases have involved, amongst others, well know companies such as AIU Insurance Company (the first case), Nippon Roche KK, Coca-Cola Japan and Ciba-Geigy Japan Limited.

US Tax Reform Act passed to preside over the growing importance of intangibles. The act established the "super royalty" provision into S482 regulations: "Income with respect to such transfer or licensed shall be commensurate with income attributable to the intangible."

This can be seen as one of the first controversial steps of IRS because it indicates IRS second-guessing and therefore a departure from ALP.

- 1987

Canada issued Revenue Canada Information Circular Number 87-2: "International Transfer Pricing and other transactions".

The Netherlands published their own standard treaty which closely follows OECD Article 9, the only difference with regards to a belief that specific service agreements are by definition are not caused by corrupt relationships.

- 1988

Following the previous years actions in Canada another more prescriptive step was taken. S233.1 of Income Tax Act issued requiring a firm to annually fill in form T106, Corporate Information Return, to show non-arm's length transactions with non-resident persons.

Significant penalties also introduced for failure to comply.

Serious of approach to transfer pricing also demonstrated in a reorganisation, around this time, of Revenue Canada Head Office to establish International Tax Progress Directorate.

The UK embodied transfer pricing rules in S770-773 of Income and Corporation Tax Act 1988.

Most importantly to occur in this year was the publication, in the US, of what is commonly referred to as the White Paper, a discussion draft: "A Study of Intercompany Pricing." The paper included an outline of controversial regulations for implementation of "commensurate with income" standard for intangibles. Additionally, methods were more detailed and documentation requirements more demanding. The main issue, however, was the proposal of CPM as an alternative to the traditional transaction methods.

Nineties

Transfer pricing has reached peak popularity, high on both the tax authorities and taxpayers agendas.

- **1990**

The EU Arbitration Convention was signed by twelve member states.

South Korea established transfer pricing rules into Office of National Tax Administration Order Number 1062.

Two years since the White Paper comes the US Revenue Reconciliation Act requiring more documentation requirements with new stiff penalties of 20% on top of additional tax if IRS adjusts taxable income by at least \$10 million.

This year also marked by inception of APA programme.

- **1991**

Rev. Proc. 91-22 authorises Canada and a taxpayer to write an APA.

- **1992**

The final occurrence in 1992 was the EC issue of draft convention on transfer pricing arbitration.

The above proposed regulations resulted in the OECD setting up a taskforce to review them.

In 1992 US issued proposed regulations which covered transfer of intangibles, contained none of the disclosure or document requirements in the White Paper (or 1993 temporary regulations) and endorsed CPM.

The second publication of the US in this year was the result of a number of hearings on transfer pricing in 1990 and 1992 and called "Issue of Foreign Income Tax Rationalisation".

- 1993

Australian Tax Office created a transfer pricing unit of International Tax Branch. In addition, Richards (1993) reported that the Taxation Office issued draft ruling TR93/D40 which all it does is indicate that the Taxation Office intends once again to give increased attention to transfer pricing.

Canada also concerned with APAs released exposure draft, after two pilot cases had already been tested, allowing consultation between taxpayers and the authorities for this purpose.

Japanese introduce polices with focus on intangible property between foreign parent companies and their Japanese subsidiaries.

Netherlands published new standard rulings regarding holding, licensing, financing, and cost-plus activities.

Additionally authorities released statement that the Rotterdam Tax Inspectorate would be the only body to hear applications for APAs involving potential investors.

OECD set up taskforce in order to undertake revision of 1977 and 1984 guidelines.

US issued temporary regulations which lists several factors to aid in best method selection process. Formally presented CPM and introduced the profit-split method. APAs encouraged in this paper. The Omnibus Budget Reconciliation Act introduced

accuracy-related penalties, under section 6662 of S482 regulations (Coopers and Lybrand, 1995b).

- 1994

Commissioner of Taxation in Australia introduced Income Tax Ruling TR94/14 - Transfer Pricing and Profit Shifting, signalling beginning of number of rulings and commitment of significant resources to tax avoidance. Rulings on matters such as ALP methods, documentation requirements and penalties.

Canada took more action with tax avoidance one year later. The Federal Budget introduced legislation to restrict income earned in Canada seeping into a low tax country.

Revenue Canada moreover issued a joint press release with the Department of Finance providing further transfer pricing guidelines (to Circular 87-2).

OECD published Transfer Pricing for Multinational Enterprises and Tax Administrations, Discussion Draft of Part One: Principles and Methods. The latter provides detailed descriptions of the three different transaction methods with additional introduction of TNMM as alternative method. The Report admits that the US CPM has some strengths as well as weaknesses.

Penalties advised to be applied in a fair way.

The US final regulations were issued incorporating the "best method" rule. CPM reduced in value from previous papers.

Additionally, under S6662(e), in S482 regulations, there is relief from penalties when a company enters into an APA.

- 1995

Australian Tax Authority unhappy with lack of seriousness paid to transfer pricing requirements by firms that it announces an increase in audit activity.

EU Arbitration Convention came into force and taxpayers able to present their case to number of bodies if they disagree with rulings made on them.

The OECD published part two of the guidelines on intangibles and services and then later into 1995 the whole report: Transfer Pricing for Multinationals and Tax Administrations. Acknowledges difficulties in application of methods. Lack of recognition of burden on taxpayer with documentation requirements. Against global formulary apportionment method. Briefly discusses possibility of APAs.

In South Africa legislation on transfer pricing was incorporated into the Income Tax Act. According to Louw (1998), taxpayers are required to show that the sales of goods and services between "connected persons" who are managed or controlled in and outside of South Africa respectively are supplied or acquired at arm's length prices.

The US issued Announcement 95-40, Proposed Update of Advance Pricing Agreement Revenue Procedure. Largely restates Rev. Proc.91-22 with new measures to ensure views of taxpayers and Service personnel are represented fairly. In this paper the IRS shows preference for bilateral or multilateral APAs.

- 1996

On December 30 1996 Brazil passed a bill to introduce transfer pricing rules.

France enacted a law amending the transfer pricing rules from a procedural standpoint and has given greater power to the French tax authority to contest abusive transfer pricing practices (Layne, 1996). As part of the changes, the tax authority can demand information more speedily from a taxpayer instead of through a lengthy exchange of information process which was the norm previously.

OECD released an update on intangible property and Intra-group services in the above 1995 report. Expanded intangibles definition to include marketing activities. Report expresses support for profit-split method. Also introduces concept of hindsight adjustments, a view more in line with US S482 regulations and one which contravenes existing European tax authorities opinion. Update believes charges for services should be commensurate with benefits. Finally the report concedes that there will be cases where service transfers should be acceptable at cost.

South Korea joined the OECD in December 1996. Borstell et al (1997) noted that as of January 1997 South Korean taxpayers were required to provide detailed information in their tax returns about their intra-group transactions (similar to the requirements of the guidelines).

- 1997

The Australian Taxation Office released an advance ruling (TR97/20), to replace a draft 1995 ruling, setting out the eligible TPMs for cross-border transactions between associated legal entities (Riley and Diamond, 1997). Richards (1997) summarised the contents of this report as setting out: "the TPMs acceptable to the tax office, when they are considered appropriate, and the tax office's views on the concepts involved and the definitional issues that arise in applying them." In general the ruling appears to follow the OECD guidelines.

In April, Brazil issued new transfer pricing regulations. Provides important guidance on the application of transfer pricing rules on a number of important issues and accepts the OECD principles of comparability (Wolf, 1997). Burden of proof shifted onto tax authorities.

Canada introduced new transfer pricing legislative initiatives in the 1997 Federal Budget and draft amendments were released by the Department of Finance in September (Mawani, 1997). These measures involved incorporating new contemporaneous documentation and reporting requirements similar to existing OECD guidelines. Canadian Income Tax Act amended to ensure all transfer pricing methods in the OECD guidelines are available to taxpayers, including TNMM and the profit split method (Forster, 1997). Also introduced penalties commensurate with degree of adjustments equal to 10% of the transfer pricing adjustment when taxpayer fails to make reasonable efforts to determine arm's length prices and allocations.

France also imposed new legislation in accordance with OECD guidelines because of problems with under compliance amongst firms.

Japan announced plans for tax reforms which include intentions to accept TNMM.

According to Chip and Coronado (1997), 1997 Mexican income tax reforms requires companies with international related-party transactions to document that their transfer prices were determined in accordance with the arm's length standard. Companies must document that one of the TPMs specified by law has been engaged. MacDonald (1997) noted that failure to pay taxes due to non-compliance with transfer pricing rules have been reduced by 50% when documentation requirements are met.

Poland (a non-OECD country) adopted OECD transfer pricing model as law. Ministry of Finance training staff to develop teams to carry out audits. Problems of consistency with 49 regional tax offices. Focus on royalty transfers and documentation.

South Korea have new transfer pricing rules requiring contemporaneous documentation to support the transfer pricing regime opted by a company. Regulations, "effectively embrace ALP and the OECD methods. Must additionally justify why three traditional transaction methods not appropriate if another method used.

Sweden expected to gather a legislative working group, under a government directive, to review their current legislation. APAs may be accepted into new laws.

The UK Inland Revenue issued "Modernisation of Transfer Pricing Legislation", a consultative document, with the objective of making legislation more similar to the 1995 OECD guidelines. Changes include new documentation requirements, penalties and higher compliance costs.

It appears that the nineties so far have involved the most action particularly after the issue of the OECD 1995 guidelines and US 1994 final regulations. As far as the influence of the OECD (in particular) and the US on other countries is concerned, it appears that developed countries were more immediately affected by the directions of the two and have been quick to follow their actions. On the whole, only recently have developing countries really caught on to the benefits of implementing transfer pricing legislation.

INFLUENCE OF THE OECD AND US

PART B

MODERNISATION OF THE UK TRANSFER PRICING LEGISLATION

The timeline showed that the influence of the OECD and US has been far reaching. The second half of this chapter is concerned with how one country has been effected by the OECD. The UK has been chosen because of the current plan to modernise the transfer pricing legislation in line with the guidelines. The chapter investigates the current legislation, followed by a look at the objectives of the change and finally a look at the important aspects of the changes to legislation.

Current UK Legislation

Currently, the UK transfer pricing legislation is embodied in Section 770-773 of Income and Corporation Tax Act of 1988 and endorses the use of the arm's length pricing although none of the methods, traditional transactional methods or otherwise, are explicitly mentioned.

An excerpt of Section 770 reads as follows: "In computing for tax purposes the income, profits or losses of the seller where the actual price was less than the arm's length price, and of the buyer where the actual price was greater than the arm's length price, the like consequences shall ensue as would have ensued if the property had been sold for the arm's length price."

The legislation enables the Board of the Inland Revenue to give a Direction requiring certain transactions between associated parties to be taxed as if parties had dealt at arm's length (MacFarlanes, 1997). According to the Inland Revenue (1997c), the existing transfer pricing legislation is discretionary: unlike most of the provisions of the Taxes Acts, it does not apply to any transactions within its scope "unless the Board so direct" (Section 770). This means that, as the legislation stands, taxpayers are not under any obligation to apply the arm's length principle in filing their tax returns (Ernst and Young, 1997b). This represents a problem, firstly, to the Inland Revenue who are faced with the responsibility for substituting the appropriate arm's length prices when this has not already been done, and secondly, a competitive disadvantage to those taxpayers who are acting properly and expending resources in order to apply the ALP to their transactions.

In addition to the legislation, the Inland Revenue issued guidelines (1981) to foreign-owned taxpayers which described, amongst other things: the definitions of scope and control; the power of the Inland Revenue to demand information with their assurances that the information would not be disclosed except for tax purposes; that taxpayers could expect adjustments where prices were found not to be at arm's length.

The main point to make here is that the Inland Revenue has been and presently is expressly guided by the considerations set out in the OECD report on transfer pricing most recently released at the time of investigations.

As Chapter 2 of the Modernisation of Transfer Pricing Legislation paper says, "It has generally served its purpose well, and embodies the ALP, but it is increasingly perceived as falling behind developments in the global economy, international trading and world-wide fiscal

practice". The fact that the onus is on the tax authority, the Inland Revenue, to ensure firms use the ALP is, in itself, an outdated concept. The removal of the directional basis and the planned integration of transfer pricing within the self-assessment framework will move the burden onto the shoulders of taxpayers to act correctly.

Proposed UK Legislation

In 1995, the then Chancellor, Kenneth Clark, in the UK Budget, initiated an informal consultation to discuss procedural changes regarding bringing transfer pricing within the self-assessment system (Elliott, 1998 and Freshfields, 1997). The announcement was greeted with concern as to the direction of this change. Guy Sellars speculated that the new system would operate similarly to the one in the US (Ernst and Young, 1995). Cannon (1997) noted that remarks of Levy Gee who expects to see the UK move towards an American system of self-assessment: "We will have the same bullish tactics here." It was announced in the following year's Budget that changes would involve bringing transfer pricing within a self-assessment framework. The current Chancellor, Gordon Brown, announced in his budget in July 1997 that he intended to update the transfer pricing rules and publish draft legislation by the end of that year.

On 10 October 1997, the Inland Revenue published the Consultative Document (ConDoc) entitled "Modernisation of the Transfer Pricing Legislation". The paper contained plans for the biggest change in almost 50 years on governing the ways that multinationals apportion the profits they earn in different countries. One reason given for the revolution of the legislation was that by being able to reach an international consensus on how transfer prices are

evaluated, tax authorities are able to protect their own tax bases, eliminate a potential source of double taxation and encourage international trade. International assent increases in importance with increasing globalisation of international business, particularly considering how much of this activity involves multinational companies. The issues are more important for the UK than other countries because Britain is more dependent on international trade and investment (Stefan Wagstyl, 1997).

Although the proposed changes could have been predicted, especially with the developments of the OECD in recent times and the number of countries who have responded to this, the shock to multinationals has been the substantial compliance burden they will be expected to face.

The Governments' stated, intended changes are to:

- a) remove the directional basis of the legislation, thus requiring taxpayers to apply the arm's length principle in making their tax returns;
- b) modernise the legislation more generally;
- c) modernise the administrative arrangements by integrating transfer pricing within the SA management framework; and
- d) reinforce the UK's commitment to the arm's length principle on which there is international consensus expressed in Article 9 and the OECD Guidelines (Inland Revenue, 1998b).

This rest of this chapter looks at the intended changes to achieve the above aims introduced by the Government, the initial responses from taxpayers, in particular Coopers and Lybrand, KPMG and Ernst and Young, and the impact of these criticisms in altering the rudimentary form of the legislation.

Andrew Hickman (1998), International Specialist and Competent Authority Specialist at the International Division, noted that as a result of the criticisms received some changes were necessary. In general, however, he said that there was broad support for the principle of modernisation and alignment with OECD guidelines and that was something which he expected. Chris Rolfe (1998), International Tax Partner at Coopers and Lybrand, London, noted that this is because the issue has been around and debated for a long time in the UK.

The Basic Pricing Rule

5.3 The new rule is intended to reproduce in UK law the effect of Article 9(1) of the OECD Model Tax Convention.

5.4 The basic pricing rule in Schedule 28AA refers to the "provision" between two persons by means of a transaction or series of transactions. It requires the adjustment of income, profits or losses where that provision (being the sum of all the terms and conditions attaching to the actual transaction or series of transactions) departs from the arm's length standard and creates a potential advantage for the purposes of UK taxation..

Many respondents including Deloitte Touche Tohmatsu (1997) noted with concern that this rule was extremely widely drawn. Some were worried, according to the Inland Revenue (1998a), that the legislation might go beyond what was envisaged by the OECD. This is because of the use of the all encompassing term 'provision'. Rolfe (1998) said of the rule, "I can't think of anything else they might want to put in there, I mean, that means everything basically."

KPMG (1997) were concerned with the effect of the rule on the record keeping burden of firms because, "it is so wide in its scope that it may often involve documentation of many aspects of a company's arrangements with its affiliates that simply are not directly related to the transaction in question".

The Government's response to this was to say that, although the wording of the basic pricing rule is broad, the requirement to construe the rules in a consistent manner with the OECD and with the production of transfer pricing guidelines, the taxpayer can be assured that of the UK legislation not going wider than the OECD's.

One-Way Street

5.5. A potential advantage exists if, as a result of the actual provision, the taxpayer's income or profits are less than, or its losses are greater than, they would have been had the arm's length provision been made between the affected persons. The new rule permits adjustments only where these will increase taxable income or profits, or reduce allowable losses. In this way, it preserves the "one-way street" approach of the existing legislation and is consistent with the approach of Article 9(1).

A number of the respondents to the ConDoc perceived the operation of a one-way street to be inconsistent with the ALP. Coopers and Lybrand (1997a), said that they believed this would go against one of the stated Key Reasons for Change, to "ensure fairness between taxpayers in the requirement to apply the ALP". They also pointed out that Article 9(1) does not object to a two-way street being adopted, as hinted at by the Government in the above section, and which

provides for adjustments to be made on an 'appropriate' basis. Similarly, the wording in Article 9 of many double tax treaties favours the use of adjustments either way.

The Government argued otherwise, maintaining that the "one-way street" approach is a basis of the existing legislation, and an integral part of the tax treaty network, and therefore, that the new rules did not represent a change. Their justification for such an approach was that taxpayers facing an adjustment in the UK would be able to seek relief from double taxation under the mutual agreement procedure of the relevant tax treaties or the new UK rules on the elimination of double counting which are expected to be introduced. In addition, the Government said: "To adopt a 'two-way street' approach in the UK might mean that taxpayers could make downwards adjustments, even where there was no upwards adjustments elsewhere. This could lead to profits going untaxed anywhere."

Secondary Adjustments

5.7. Unless the adjustment in the tax computation is matched by payments between the affected parties reflecting the adjustment, the economic circumstances of the parties will be distorted.

5.8. One way of addressing the distortion is to make a "secondary adjustment", which recognises the fact that funds which would have been retained by one of the parties of the provision had been made at arm's length have not actually been retained. This is done by deeming a secondary transaction, for example a loan, to have been undertaken.

5.9. The Government does not propose to provide for such adjustments, but will keep the position under review to determine whether legislation is needed to ensure funds are restored following a transfer pricing adjustment (voluntarily).

Responses: "suggested that any payments should be treated on the same basis as payments for group relief. It was also suggested that the secondary adjustment might take the form of a one-off tax payment, to be made at the time of the primary adjustment, equivalent to the net present value of the tax projected to be generated by the 'missing' funds" (Inland Revenue, 1998a).

KPMG (1997) wanted to know how the Government intended to encourage voluntary repatriation of funds; however, Ernst and Young (1998a) felt that in a majority of cases this would not be an issue.

There was general agreement with the Government's intention not to provide for secondary adjustments. KPMG (1997) were questionable about the Inland Revenue not being specific in their intention not to (ever) impose secondary adjustments. Ernst and Young (1998a) thought that such a provision would be unworkable, particularly if cases involved a number of periods.

The Government did not change its opinions on secondary adjustments, so they will not provide for them in the legislation.

Scope of the Legislation

The ConDoc's proposals incorporated an extension of the control tests.

- Definition of Control

5.10. The current legislation applies to transactions between parties where one party controls the other or both parties are under common control.

5.11. Under present legislation, the test at section 840 is employed to establish whether the requisite control conditions are fulfilled. In applying this test, rights and powers of nominees and connected persons can be attributed to the potentially controlling party. The draft legislation continues to employ the test for partnerships, but adopts section 416 for companies. The proposed legislation also incorporates a series of attribution rules, including provisions which address situations where trusts or unit trusts are included in a control chain.

Many respondents expressed concerns with the rules for determining control. In particular, Coopers and Lybrand (1997a) felt that the need to test first the direct relationship and then the indirect relationship of the parties represented an unfair and onerous burden. They recommended either of the following:

- the proposed attribution rules be removed from the main body of the proposed legislation and contained instead in an anti-avoidance paragraph for which a Board direction and the involvement of International Division are required; or
- taxpayers who have not set out to abuse transfer prices are protected from the prohibitive costs of researching indirect relationships by the inclusion of a 'knows or should have known' rule.

In addition, much concern expressed, by respondents, was directed at the effect of the partnership attribution rules. Coopers and Lybrand (1997a) wanted only the relevant relationships to be taken into account, by which they meant not to encompass partners "with interests which do not exceed 50 percent after attributing to the tested party all interests in that partnership held by connected parties from the control definition". The Government's reaction to this view, and the second of their proposed changes, was to drop such rules.

Two changes were announced by the Government with regards to their proposed legislation after receiving comments. There would be a change in the definition of control for companies, defined by reference to section 840 ICTA, and not section 416 as originally proposed. One consequence of this will be that otherwise unconnected parties will not be deemed to be connected solely because of a loan relationship between them. In addition, the legislation would be amended so that a control relationship will not necessarily be created between a lender and a borrower by reason solely of the lender taking a charge over the assets of the borrower as a security for the loan.

With regards to the protests over the partnership attribution rules, the Government proposed to drop them.

The aim of the changes is to narrow the original intended scope of the legislation to a level more acceptable to companies.

- Joint Ventures

The new definition of control brings within the legislation joint ventures between two 40% participants (Ernst and Young, 1997b). Coopers and Lybrand (1997a) said the proposed

change represented a severe departure from the existing 50 percent rule. In addition, this is, arguably, an unnecessary extension of the compliance burden.

KPMG (1997) argues that since joint ventures are a means by which UK companies are able to penetrate 'emerging' markets, the instances where there are "entirely commercial arrangements for working with third parties may be put at risk".

Coopers and Lybrand (1997a) argued that it may not be in the power of the UK company to insist on changes in a joint venture agreement and that competent authority claims were likely to be unsuccessful if a proposed UK adjustment would exceed the profit attributable to the UK party under the joint venture agreement.

The Government decided that, despite the criticisms, it would bring the new joint ventures definition into the legislation. However, to allow UK participants who would need to renegotiate their position in agreements involving arm's length pricing the Government proposed to introduce a three year transitional period in the legislation which would act as a "grandfathering" provision to existing joint ventures.

Financial Transactions and Arrangements

5.19. All financial arrangements between or involving "the affected persons" are potentially within the scope of the proposed new legislation.

The Government said that this was a natural progression to bring the UK legislation more in line with Article 9 of the OECD Model.

Coopers and Lybrand (1997a) felt that the impact, of bringing all financial transactions within the boundaries of the new legislation, on inward and outward lending of UK companies raised a number of "complex pricing issues". They used, as an example, the existence of an affiliated company guarantee, which not only affects the level of debt which a bank is willing to extend to a company, but also the terms under which such a loan is made.

5.20. Where the funding comes directly from a third party, but with the support of a guarantee from a non-UK group member, "excessive" interest will fall to be disallowed, as is sometimes the case now, if the provision between the two affected persons differs from the arm's length provision.

A number of respondents expressed concern at the intention to disallow interest on third party funding backed by guarantee. The Outcome of Consultations (Inland Revenue, 1998a) paper mentioned that responses had been made questioning how such a system could be implemented and requesting assurances that the legislation would not apply where the borrower was not thinly capitalised and the only effect of the guarantee was to reduce the interest rate or secure better terms. The Government responded by introducing plans to issue guidance on the application of the new rules, to be consistent with existing thin capitalisation rules.

KPMG (1997) said that if the Inland Revenue were to disallow interest of a UK subsidiary on a bank loan guaranteed by an associate, it appeared unlikely that there would be any

mechanism by which double taxation could be avoided. Similarly, double counting could occur as a result of a corresponding adjustment which might not have been available under the relevant Double Tax Treaties.

"Since the new rules adopt the Article 9 approach, there will be no change where a borrower obtains loan funding from an unconnected lender under cover of a guarantee provided by an associated company resident in a country with which the UK has a tax treaty incorporating a provision of this type. The proposed legislation will, however, extend this approach to all such arrangements irrespective of the existence, or particular wording of, a double taxation agreement, thus achieving greater consistency in the application of the rules" (Inland Revenue, 1998a).

Foreign Exchange and Financial Instruments

5.22. Transactions which are within the scope of the new legislation may give rise to foreign exchange gains and losses, and to payments and receipts under financial instruments. Special tax rules for such amounts are set out in Chapter II Part IV FA 1993 (foreign exchange gains and losses) and Chapter II Part IV FA 1994 (financial instruments). Where amounts are brought into account under those provision they will be excluded from consideration under the transfer pricing legislation.

The above exclusion received support from a number of respondents.

5.23. There are at present specific provisions which deal with the adjustments to be made where arrangements which give rise to foreign exchange profits and losses or payments and receipts under financial instruments are other than at arm's length. These provisions only apply where the Board of Inland Revenue give a Direction to that effect.

5.24. The Government believes that in principle these provisions should be applied when taxpayers self assess their profits, without the need for a Board's Direction.

Coopers and Lybrand (1997a) and Ernst and Young (1998a) both argued that given the complexity of the legislation, the Board's direction should be retained. If the provisions were to be brought within the self-assessment framework, Coopers and Lybrand (1997a) requested the following areas of taxpayer protection be provided:

- The safe harbour guidelines set out in section 3 of the Explanatory Statement should be preserved in statutory form, so that a company can rely on them when fulfilling its self-assessment obligations. If the taxpayer could show that it had behaved reasonably in assuming that the company was within a safe harbour, it should not be exposed to a penalty.
- The foreign exchange arm's length tests should be amended to operate on a proportionate basis. At present, if a loan is caught, the whole of an exchange loss is carried forward and ring fenced.
- To be consistent with Schedule 28AA (and the existing rules for debt) there should be an exclusion from the arm's length test for currency contracts where the contract is between two members of the same UK group.

The Government has, regardless of the criticisms expressed, decided to abolish the use of the Board's direction before the anti-avoidance provisions relating to foreign exchange differences

and financial instruments. Legislation will be used to ensure that Inspectors are unable to impose the application of these provisions without obtaining the approval of Head Office first.

Commencement

5.3. On the basis of integration within the SA framework, the Government intends that the new regime for transfer pricing should come into effect at the commencement of CTSA.

The designated date for initiation has been announced as 1 July 1999.

Ernst and Young (1998a) asked the Government to appreciate the fact that companies do not, as a matter of practice, routinely record every discussion and arrangement they enter into, and to expect them to have the documentation in place for transactions occurring before July 1998 would place an intolerable burden upon them. KPMG (1997) would have preferred the start date be delayed by one year, but as this would be an unlikely suggestion some form of transitional relief for arrangements in place at the commencement date.

The Government have taken heed of these concerns and promised to adopt a 'common-sense' approach towards taxpayers and the difficulties they may experience in adopting the new system. The expected date of inception remains July 1999.

Central Monitoring of Transfer Pricing Enquiries

6.5. Central Monitoring under the responsibility of International Division in two ways.

6.6. Firstly, responsibility for the statutory Direction procedure to senior officials of the Division ensures that the Inland Revenue adopts a consistent approach in this complex, specialised and sensitive area.

6.7. Secondly, cases are brought to the attention of the Division through a more general system of submissions to Head Office.

Coopers and Lybrand (1997a) suggested that in the initial enquiry stage, involving local non-transfer pricing specialist inspectors, the Inspectors Manual (IM4661) should require them to:-

- restrict initial questions to the minimum necessary to determine whether and to what extent a transfer pricing investigation might be required;
- conduct any investigation in an ordered manner, perhaps agreeing with a taxpayer that different elements of its transfer pricing will be considered on a rolling basis year by year and avoid the "scatter-gun" approach;
- in relation to a field enquiry, explain what it is that the enquiry is addressing and what is the Inspector's specific concern;
- when presented with an argument in support of a position, respond with counter-argument which the taxpayer can address; and
- be obliged to refer to International Division any concerns of the taxpayer about the conduct of the enquiry (e.g. burdensome requests).

As a result of this criticism and those made by others the Government announced plans for some changes to IM4661. "The Revenue is considering how best to afford taxpayers access to International Division without prejudicing the Revenue's ability to undertake effective compliance work. The new IM4661 will form part of a more extensive revision of the published guidance of Inspectors on transfer pricing; this will be available before the first CTSA (Self Assessment for Companies) filing date."

6.9. The Government intends that central monitoring of enquiries should continue following the proposed abolition of the Board's Direction procedure.

Arguments for the removal of the directional basis include the fact that it would remove inequity and potential competitive disadvantage between taxpayers, and bring the UK more closely in line with what happens in other countries (Macfarlanes, 1997a). In addition, removing the direction imposes on taxpayers the obligation to apply transfer pricing appropriately themselves through the self-assessment framework. This would not be consistent with the continued use of the Board's direction.

After receiving comments on this proposal abolition, the Government intends to remove the Board's Direction only with regards to foreign exchange difference and financial instruments.

KPMG (1997) were amongst the respondents who believed in the maintenance of statutory central monitoring and the Direction system to afford the most protection to taxpayers. Arguments in favour included the notion that taxpayer protection could not be achieved satisfactorily through the operation of a purely administrative procedure. In the absence of this, they requested the enactment of 30C TMA (Appendix 5). Coopers and Lybrand (1997a)

said that in the necessary enactment of the latter they felt "that it should be expanded in two ways: firstly, to cover more than the assumptions of paragraph 1(2) of Schedule 28AA since the experience of International Division is likely to be required to ensure the proper and consistent application of the OECD Guidelines (paragraph 1(3)) and the proper conduct of complex enquiries; and secondly, that a taxpayer can refer to the International Division where it has grounds for believing either that an investigation under Schedule 28AA is being conducted in an oppressive or unreasonable manner, or that it is being conducted without a reasonable expectation of approval from the Board for an adjustment.

Following the universal support for enshrining the central monitoring of enquiries into the new legislation, the Government announced its intentions to keep the "Board's Approval" mechanism.

Compliance Costs

KPMG (1997) requested confirmation as to the definition of a 'disproportionately high cost' (used in paragraph 6, Appendix II) so as to inform the debate on the extent of documentation required.

Ernst and Young (1998a), on the other hand, wanted more clarification on a number of issues, including penalties so that companies could satisfy themselves that they could be at risk from a minimal level of damages as possible. This too would help the Government and their objective to keep compliance costs as low as possible for firms.

As a result of such opinions towards compliance costs the Revenue is to produce a Regulatory Appraisal of the proposals on transfer pricing, including a Compliance Cost Assessment. Revision of the guidance on documentation and changes to the control rules are also intended, to help meet some of the concerns on clarification.

Both KPMG (1997) and Coopers and Lybrand (1997a) wanted to see some confirmation from the Government that all costs incurred by a taxpayer, including those involved in meeting the compliance burden and, as Ernst and Young (1998a) suggested, the professional fees charged, would be fully tax deductible. In addition, KPMG (1997) brought attention to the idea that the Revenue should be obliged to consider financial redress if no adjustment is made and the Revenue have placed unrealistic demands for information on the taxpayer.

The Government decided to allow tax deductibility for all pre-filing costs of transfer pricing cases as long as they meet the rules on admissibility of expenses.

Return Requirement

6.21. The Government has decided not to impose any requirement upon taxpayers to disclose information about transfer prices in their tax returns. However, it has asked the Inland Revenue to keep under review the effectiveness of the administration of the proposed new regime in this respect.

This attracted widespread agreement, although some thought that a limited return requirement might be preferable, if the result was greater taxpayer certainty (Inland Revenue, 1998a). The existing Taxes Management Act record keeping requirements, however, will still apply.

Documentation Requirements

6.23. Section 12B will be interpreted by the Inland Revenue, for the purposes of transfer pricing rules, according to Chapter V of the OECD Guidelines: Expect documentation to be created, referred to and retained in relation to a taxpayer's transfer pricing arrangements with the same prudent business management principles that would govern the process of evaluating a business decision of a similar level of complexity and importance.

6.24. Taxpayers will be expected to create and retain contemporaneous documentation of their efforts to comply with the ALP, including the information on which their transfer prices were based, the factors taken into account and the method selected. The Inland Revenue proposes to issue guidance in this area.

This section attracted considerable attention from respondents concerned with the expectations of the Government, namely the compilation and upkeep of a contemporaneous level of documentation.

Coopers and Lybrand (1997a) stressed that the list of items expected to be retained was not a realistic reflection of what would be readily available to the ordinary prudent business person. They thought the list far too long and that many items might not be relevant. KPMG (1997) wondered whether the Inland Revenue believed that companies routinely maintained the level

of documentation detailed in Appendix II of the ConDoc, and if they did, then KPMG felt they must be under a misconception.

Appendix II states that taxpayers are not expected to determine the 'best method' yet, as KPMG (1997) questioned, how would taxpayers demonstrate they had considered the arm's length provision if they have not looked at comparable data and the methods available. Ernst and Young (1998a) was also concerned about this contradiction, particularly the resultant taxpayer uncertainty.

In addition, as Ernst and Young (1998a) pointed out, not every transaction, meeting or renegotiation, for example, between parties acting at arm's length is fully recorded. If it were the norm to do business in certain industries with the minimum of documentation then the Inland Revenue should recognise that fact.

The cost of complying with the proposed legislation may be unreasonable; Coopers and Lybrand (1997a) quoted one of their taxpayers: "For a large multinational enterprise with many cross border transactions this would involve collating reviewing and keeping copies of thousands of documents - an expensive paper chase. This makes Dawn Primarolo's assertion that 'compliance costs should be kept to the minimum necessary' look rather hollow."

Furthermore, how were the smaller and medium sized companies expected to cope with this increased cost? Ernst and Young (1998a) suggested a narrower, more defined list of requirements. The Outcome of Consultations (Inland Revenue, 1998a) paper noted an alternative expressed by some respondents for a system of governmental guidance, as opposed to a prescriptive list, which would involve taking account of the documents which businesses

create and keep for commercial reasons, and recognising that different businesses have differing needs in this regard. Coopers and Lybrand (1997a), believed the recommended list should be reduced to the following three items: identification of relevant transactions; which TPM was used; and how it complied with ALP. The result would be a decrease in the compliance burden, relieving in particular the smaller companies.

Along the same line, Coopers and Lybrand (1997a) suggested the introduction of a minimum documentation requirement where maintenance of such would mean that companies could not be charged with neglect. Additionally, they wanted the legislation to introduce a permissible margin of error, "to reflect the fact that transfer pricing is a question of ranges and depends on data which may be difficult to obtain and interpret".

Ernst and Young (1998a) and KPMG (1997) both wanted to know what the Inland Revenue considered 'available to them' to actually mean. Ernst and Young (1998a) expressed concern at the idea that information availability might be assumed to be based on the concept 'if it is out there' and the associated problems, including the cost factor, for MNEs expected to keep extensive databases if they are to review the information availability.

There was general concern at the scope for creative interpretation that local Inspectors may take with regards to the regulation. In addition, the possibility of unreasonable information requests in the course of an enquiry and the prospect that an inability to provide certain items might lead to a verdict of guilty regardless of the relevance of such data to the case. Moreover, Ernst and Young (1998a) talked about the problem of time delays when an Inspector is obliged to refer a case to the International Division before seeking to issue a

penalty, and the likelihood that a company will pay the penalty just to see the matter resolved quickly, regardless of the actual ruling which may finally be made.

The Government had a limited response to the criticisms outlined above. It was accepted, however, that the draft guidance note needed revision in order to lay greater stress on the establishment of broad principles, and less on the identification of particular types of document.

The Government agreed with the introduction of transfer pricing ranges and acknowledged that because of the subjective nature of transfer pricing, they would allow prices to fall within a prescribed acceptable range.

On a concluding note, it can be said that despite the Inland Revenue's obvious attempts to reduce the extensive documentation and record keeping requirements, the compliance burden will be substantial if the approach of the ConDoc is fostered. Mike Godbee (1997), transfer pricing partner at Coopers and Lybrand, London, found, in response to a questionnaire, only 27% of companies considered that they currently complied with the new standards for documentation. Furthermore, he said : "We expect that many companies, particularly inbound investors, will need to make a real effort to obtain sufficient documentation to be able to file complete and accurate returns under the new legislation without losing sleep."

Penalties

6.31. If a return does not comply with the transfer pricing legislation, it will be an incorrect return, and if it is incorrect as a consequence of the taxpayer's fraud or neglect, then the taxpayer will be liable to a penalty.

6.32. The maximum amount of the penalty eligible under these provisions is equal to the amount of the tax lost as a result of the fraudulent or negligent conduct.

6.33. The Government does not propose to introduce specific penalty provisions.

6.34. Taxpayers should not be penalised if they make a reasonable attempt to comply by observing the arm's length standard in their tax returns. Clearly, it is important for taxpayers to have appropriate records to demonstrate what they have done in this area.

6.36. Where there is a liability for penalties, the Board of Inland Revenue, will exercise their discretion to mitigate the penalties charged as appropriate based on the extent to which the taxpayer has disclosed any irregularities, the co-operation afforded and the size and gravity of any offences committed.

The proposals in this regard represent the greatest shift from the current regime (Ernst and Young, 1997b). There is no current legal requirement for firms to show that profits have been computed in accordance with the arm's length standard. Because of the change KPMG (1997) said they felt the penalty regime should be applied less harshly in the early years and Ernst and Young (1998a) suggested a three year transitional period.

KPMG (1997) requested the Inland Revenue issue a Statement of Practice on penalties and they requested information on what would be considered to be mitigating factors and how those factors would be applied. Coopers and Lybrand (1997a) suggested the use of a safe

harbour rule, whereby no penalty could be applied where the amount of the adjustment failed to exceed a given percentage of profit and an absolute amount.

These criticisms led the Revenue to announce that they would produce a statement, "with illustrative examples, indicating when it would consider penalties appropriate in respect of transfer pricing adjustments, and outlining how the Board's criteria for the mitigation of penalties will be applied in transfer pricing cases".

Conclusion

The main point of the modernisation of UK legislation, to incorporate the basic pricing rule of the OECD guidelines into UK law, has been accepted as inevitable by all. In addition to incorporating the ALP into law the effect of the OECD on the UK update can be seen in a number of areas. These include the wide reaching scope of the legislation (for example encompassing financial transactions and arrangements) and the adoption of penalties. As far as the level of documentation is concerned, the Inland Revenue has said taxpayers should rely on Chapter V of the OECD guidelines to determine how much to produce (Deloitte Touche Tohmatsu International, 1997; Inland Revenue, 1998e and Patton, 1998). Similarly both parties refuse to recognise the extent of costs associated with the collection and maintenance of documentation. Deloitte Touche Tohmatsu International (1998a) said that the Revenue's estimated total cost of compliance of the most effected (2000-3000) businesses, during the transition period, of £25 million to £75 million was a substantial underestimation.

ADVANCE PRICING AGREEMENTS (APAs)

Birth of the American Programme

The 1980s was a time of increased dissonance and aggravation with transfer pricing in the US. This was exacerbated by the growing use of intangibles over the period and the problems they brought in finding appropriate transfer pricing methods, combined with the growing number of cases being litigated as the IRS grew increasingly confrontational (Triplett, 1994). The publication of the White Paper in 1988 was perceived as a further act of government belligerence, with legislation becoming more and more constrictive. At the end of 1989 and into 1990 the IRS held a number of discussions with taxpayers to discuss the increasing unhappiness of both parties with transfer pricing and the application of the arm's length principle.

The consequence of such talks was to introduce the idea of advance rulings, whereby an agreement was made between the Office of the Associate Chief Counsel (International) and a company, involving the transfer pricing policy to be adopted on cross-border transactions prior to them being carried out. The proposal represented a departure from previous policy, as Rehder (1996) said, "in the past the IRS has been reluctant to enter into agreements based largely on projections rather than fact". The acceptance of the concept on the side of the authorities came in recognition of the growing complexity of transactions and the realisation that the resources were not available to complete as many audits as desirable (Rehder, 1996).

Initially the agreements were referred to as advanced determination rulings (ADRs), but the name changed shortly after to advance pricing agreements (APAs) (Epstein, 1990). These APAs were formally proposed in March 1990, and the idea was finalised after further discussion with taxpayers, treaty partners of the US and other relevant bodies. In March 1991 the IRS published Revenue Procedure 91-22 which authorised APA contracts to be made between the relevant bodies and contained a number of guidelines on the formation of such an arrangement.

Few companies showed interest in becoming the programmes' guinea pigs. It was Apple Computer that first piloted an APA, in response to years of transfer pricing attention from the American and Australian authorities and the many resultant adjustments which they had previously been compelled to make. Rehder (1996) highlighted the satisfaction which Apple Computer expresses with the system of APAs, having also entered into a number of similar agreements with other countries, including Canada and Japan. The avoidance of double taxation and the certainty of tax treatment were the two reasons the company cited for preferring APAs.

It is estimated that since March 1991 approximately 300 APAs of various types have been negotiated worldwide (Ernst and Young, 1997). The countries reporting the largest number of completed APAs are the US (100), Canada (12), Australia (9) and the UK (7). These numbers indicate that, compared to the number of enterprises doing cross-border trade with related or associated enterprises, the use of APAs is still very limited.

This chapter begins by looking at different types of APAs and the advantages and disadvantages of APAs. Then it reviews the APA procedure in the US, as the best

documented and longest running system. Special interest will be shown on what aspects taxpayers are advised to consider when contemplating an APA with the US, followed by a step by step investigation of the process and guidelines of Rev. Proc. 96-53, the most recent framework for the US APA process. There have been some revisions to the APA process since the introduction of Rev. Proc. 95-22. In 1995 Ann. 95-49, for example, set forth changes to increase the flexibility of the process and, according to Laffie (1995), "to ensure that the views of the taxpayer and all involved IRS personnel were represented effectively". Critical changes from the original Rev. Proc. 95-22 format will be discussed in detail.

This chapter also discusses briefly the experience and views of other countries to APAs, with particular reference to the attempts of the UK aiming to establish an APA framework formally into their legal system.

Uni-, Bi- and Multilateral Agreements

A taxpayer may choose to form a unilateral APA, where an agreement is made between himself and one tax authority. Alternatively, a taxpayer may choose to commence proceedings for APAs with two (bilateral) or more (multilateral) jurisdictions simultaneously. This would bring about several sets of agreements between the taxpayer and the home country, the foreign affiliate and the foreign countries, and the home country and its treaty partners (Ryan and Patton, 1991). The purpose of a number of 'international' settlements are that, subject to compliance with the contracts specified terms, the taxpayer can report transactions in the different jurisdictions and not find himself subject to adjustments upon audit in any of them.

In the US, the taxpayer can elect whether his APA will be unilateral, bilateral or multilateral under Rev. Proc. 91-22. According to Gould (1997), APA requests in 1997 were about 80 percent bilateral and multilateral, and 20 percent unilateral. The next two sections aim to explain the popularity of the former types of APA compared to unilateral APAs in the eyes of both tax authorities and companies.

- Unilateral Agreements

According to Ryan and Patton (1991): "While IRS officials had indicated informally they are willing to consider requests for APAs on a unilateral basis it is clear that their primary emphasis is currently on APAs with respect to countries that are willing to enter into bilateral agreements."

It is interesting to note that when a company wishes to enter into a unilateral APA and cross border transactions involve entities in treaty countries, the tax authority concerned can disclose information, given to it by the company in the course of the APA, to foreign treaty partners under treaty provisions if asked so to do. This information may be imparted to the treaty partner for issues that may not even be related to the APA.

- Bilateral and Multilateral Agreements

The benefits of bilateral and multilateral agreements are: firstly, the likely fall in the risk of double taxation than with unilateral APAs; and secondly, the costs are minimised. The latter is partly because the taxpayer has assurance that he will not have the cost of being challenged by relevant governments and the governments do not have the cost of challenging the taxpayer or the cost of questioning other governments on their taxation of the cross-border transactions. This view is shared by Schwartz et al (1995) who said: "A move for a procedure to

encourage bilateral APAs was supported because of the adverse impact of transfer pricing enforcement on tax revenues, the deficiency in bilateral tax treaties to avoid double taxation, and the willingness of tax authorities to settle the transfer pricing issues in advance."

Ryan and Patton (1991) list the speed of the process of negotiations and the likelihood of reaching a successful outcome as two further stimuli for concluding bilateral and multilateral agreements. They ascribe this quickness in dealings to the fact that the negotiations at governmental level take place before revenue has been collected and government positions have been solidified. Gould (1997) agreed with this, having said that the involvement of all Competent Authorities, those bodies authorised to deal with the international transfer pricing representations of their countries, from the onset of the APA process and the ability of all parties to have an input shortens the final negotiating time period. Ryan and Patton (1991) pointed out the added advantage of APAs as the only way that foreign-controlled, US taxpayers can obtain any security from arbitrary IRS assessment action.

- Competent Authority

Reaching a common understanding between governments on company's results and reporting on the TPMs requires the participation of the competent authorities, and a successful outcome will mean the formation of a competent authority (CA) agreement. The taxpayer will be expected simultaneously to submit APA requests and related correspondence to the competent authorities involved to allow fair consideration from all sides at the programme's inception. By adhering to the agreed terms of the agreement, the contract ensures that the taxpayer reporting in a jurisdiction will not be subject to adjustments upon audit on these issues in any of the jurisdictions (Ryan and Patton, 1991). The US CA, responsible for dealing with international APA issues, is the IRS Assistant Commissioner (International). Rev. Proc. 96-53

said that where there was an inability to come to an arrangement among competent authorities, the Service would attempt to negotiate a unilateral APA.

With regards to the request for disclosure of specific sensitive data, which might affect the competitive position of the company if divulged, the IRS said, in Rev. Proc. 96-53, that the "parties would attempt to negotiate a mechanism to permit verification by a foreign CA without disclosing such information". Between Competent authorities the exchange of information extends beyond the initial formation of an APA. Rev. Proc. 96-53 expects information notification from foreign competent authorities "concerning any subsequent modifications, cancellation, revocation, requests to renew, evaluation of annual reports, or examination of the taxpayer's compliance with the terms and conditions of the APA". Finally, Rev. Proc. 96-53 Section 7 on CA Consideration finishes by saying on the matter of the types of APAs: "A unilateral APA may hinder the ability of the US CA to reach a mutual agreement which will provide relief from double taxation, particularly when a contemporaneous bilateral or multilateral APA request would have been both effective and practical to obtain consistent treatment of the APA matters in a treaty country.

The role of the CA is discussed in the next chapter in more detail because the main objective of such a body is the resolution of double taxation on a greater scale than just dealing with APAs.

Advantages of APAs

- Certainty of Treatment and Protection From Penalties

As a binding agreement, an APA provides a high level of comfort with respect to transfer pricing, and helps taxpayers avoid contesting expensive audits because the IRS (and any other authority) will not investigate the TPM annually (Schwartz et al, 1995). This is corroborated by Rehder (1996) who said that corporate taxpayers welcomed the opportunity to enter into APAs as otherwise legislative amendments heightened their concern that they were violating transfer pricing rules, and, therefore, subject to possible adjustments and penalties. Certainty of treatment appeared to be one of the most commonly cited reasons for entering into an APA, together with protection from double taxation. In entering into an APA, there is relief in the US from penalties under Section 6662(e). Conflict with the authority over the TPM could also bring the negative publicity of litigation. Certainty of treatment in the US comes under Section 482 regulations.

- Protection From Double Taxation

There is some protection from double taxation where agreements coincide with other countries party to an APA (Triplett, 1994). Alternatively, bilateral tax treaties may have the same effect, and are used by countries who are party to APAs in preference to unilateral agreements. Those jurisdictions most in favour include the United States, Canada, the Netherlands, Japan and the UK. The preference for bilateral and multilateral APAs in 80% of cases in the US is a demonstration of the awareness of the problem of double taxation for US-based multinational enterprises.

- Application to Other Jurisdictions

If an APA is agreed between a firm and a number of countries, Triplett (1994) commented it would be difficult for methods to be challenged by another, different country. From comments made by French and German officials (see next page), however, this does not necessarily appear to be the case.

- Review in Non-Confrontational Environment

One of the general objectives of the APA process is to create an environment that encourages common understanding and cooperation between the taxpayer and the tax authority. Wrappe (1997) said this is achieved, "because the APA process allows the taxpayer to propose and support its transfer pricing methodology, it encourages efficient communication that eliminates adversarial, position-based negotiation." Rev. Proc. 96-53 supports this view: "The APA process is designed to be a flexible problem-solving process based on cooperative and principled negotiations between taxpayers and the Service." The wording is positive and suggests meetings are held between equals as opposed to the IRS taking on the role of the accuser and the company as the defendant. The fundamental principle of the APA is to create understanding, finding solutions not problems, for the TPMs of cross-border transactions.

- Present Cases

The existing examples should give the taxpayer some confidence and increase the appeal of the APA process. These include Apple Computer, Barclays Bank, Sumitomo Bank Capital Markets, and Matsushita Electric Company (Plambeck, 1994).

- Record Keeping Burden

Ogum and Kim (1995) held that since the taxpayer and authority agree in advance on what information is relevant for purposes of the APA, this can reduce the taxpayer's record keeping burden. This is a debatable point, since the process of attaining an APA will require the production of more sensitive data than would otherwise be expected to be produced in the normal process of defending the use of a TPM to the IRS. This could, therefore, be said to represent an increasing record keeping burden, with the problem of requiring extra time to put together facts which might never have been required previously. The suggested Appendix II of the UK "Modernisation of transfer pricing" consultative document (Appendix 6) demonstrates the increasing demands for information, which is not necessarily an advantage to APAs. This is a point related to the disadvantage of information disclosure discussed below.

- Maturing of US Programme

As the programme develops agreements are being made in an ever increasingly efficacious manner (Plambeck, 1994). Revenue Procedure 96-53, according to Gould (1997), currently streamlines the bilateral and multilateral APA processes. Perhaps this will encourage the production of generic descriptions of industries as mentioned before. Over time authorities are able to refine the APA process and this should work to decrease the time necessary to complete an APA and lower the present seemingly high cost of the procedure.

Disadvantages of APAs

- Information Disclosure

All countries which participate in APAs require extensive information to be provided. The process requires a major commitment from the taxpayer's management, tax and accounting bodies. If most countries mirror the US, then in the instances when an APA is not concluded, the information gained will almost definitely be used (against the companies) in the future by tax authorities and possibly for examination of the past. The IRS offers more guidance than most on what would happen in this event.

The taxpayer must voluntarily expose itself to scrutiny by providing detailed industry and taxpayer specific information. Some procedural safeguards are needed to protect the taxpayer; for example, a company should be able to request that the tax authorities keep any disclosed information confidential (Rehder, 1996). The IRS guarantees confidentiality through section 6103, and tax treaty confidentiality provisions also apply (Plambeck, 1994). Revenue Canada offers the same protection as the Income Tax Act prohibits it from providing briefing material obtained by it regarding a taxpayer to anyone other than a specified government official (Ward and Armstrong, 1994). The taxpayer, however, should still evaluate the risks of disclosure in a treaty country (Ogum and Kim, 1995). As well as providing this information, the taxpayer may be at risk from being influenced by authorities as to their pricing decisions, which, the ICC says, "is contrary to the fundamental principles of a free market economy" (Sayer, 1995).

In developing a more flexible APA regime to encourage more firms participation, Takashi Tokunaga, general manager at the office of financing and accounting at Japan's Kansai

Electric Power Company, says that companies' wishes to retain confidential information must be taken into consideration (Sayer, 1995).

When providing detailed knowledge of a company, a MNE must also consider adverse, retroactive effects of what they may be asked to reveal, especially where this affects tax years not already agreed, and where they may inadvertently contradict previously submitted information (Triplett, 1994). The taxpayer is likely to be challenged as a consequence of this information. In Rev. Proc. Section 3.06, it says on the matter of 'rollbacks' (looking back at the results of previous years): "Taxpayers should recognise that, even absent a (taxpayer's) request for a rollback, the Service may, under regularly applicable procedures, determine that the TPM agreed in an APA should be applied to prior years." This is illustrated by Patton and Wood (1995), who concluded that as many as 80% of the US APA applications filed involved a potential investigation into the APA of material for tax years for which returns had already been committed.

A final concern, on information expected, involves the requirement that firms submit annual reports evidencing compliance with the terms and conditions of the agreement to the various, relevant authorities. These do not, however, protect the taxpayer from additional scrutiny in the future.

- Complexity and Length of Time to Complete an APA

It is debatable whether the length of time to complete an APA is disadvantageous or advantageous, since it is dependent of the revenue authority's experience with APAs (the US being the most versed) and the size and complexity of the company applying.

Notwithstanding that, the previous section examined how the US had experienced a number of 'growing pains' in the early 1990s, the result of which was a considerable slowing down of the process.

With companies constantly changing, in structure and size for instance, APAs needed to be completed speedily, since APAs only apply under a given set of conditions (Elliott, 1997). The relevance of an APA could be short-lived, even though countries are attempting to construct the programmes for longer time spans, more than the typical five year period for example. As the critical assumptions on which the APAs are based change, so the taxpayer must justify the use of the original transfer pricing methodologies, unless the APA is wholly adapted with new negotiations to meet the revised circumstances.

- Cost to Taxpayers and Revenue Authorities

The longer the process of application and approval, the greater the cost of participation. In addition, the firm may have accrued added expenses such as compiling a requested document of data which would otherwise not have been produced. This document might also have required a level of expertise that the firm would not normally internally supply and hence involve the cost of external sourcing.

Humphreys (1994) argued that, in reference to the Canadian APA process, much of the information-gathering, analysis and documentation necessary in developing an application for APA consideration requires the same effort as is necessary to otherwise assess and establish an appropriate policy and transfer price. This cost should be compared to the cost of defending an historic price through audit, CA, or through the Courts, all of which may take longer than the nine months Revenue Canada average the completion of an APA.

Wrappe (1997), argues, indeed, that significant time and cost savings are achievable through both the taxpayer and, in his example using the US, the IRS's "effective communication and narrowly defined information disclosure of the APA process".

A firm needs to weigh the direct and indirect costs of the APA against the expense of undergoing transfer pricing audits in several jurisdictions (Ryan and Patton, 1991).

- Breadth of APAs

It would be logistical nonsense to have an APA for each of a multinational enterprise's product lines as no one product line could be singled out as representative (Mazero, 1994). The previous section quoted Ryan and Patton (1991) suggested list of transactions that might be appropriate for APAs.

- Cancellation of an APA

An authority may cancel an APA at any time on the grounds of suspected fraud, or misrepresentation in the provided information, or if a company has failed to comply fully with the terms and conditions of the APA. This is perhaps subject to (too much) judgment rather than fact since most of the APAs will be based on future projections rather than specifics.

- French and German Views

Lerat, group senior vice president, tax department at French multinational Rhone-Poulenc, founds his dislike for APAs, a view consistent with the French tax authorities, as a positive action against the policies of the US (Swiss, 1995). He also strongly opposed the American introduction of CPM. According to Swiss (1995), Lerat felt resisting APAs was a step boding well for resisting the influence of the US transfer pricing regime in Europe altogether. The

French authorities are not confident that they will receive as much tax from companies with the power of the US. This concern is echoed in Germany, which has adopted a wait-and-see approach warily regarding how APAs are received elsewhere first (Rehder, 1996). The tax authorities of Baden-Württemberg holds a view held by number of other German states, that they would not readily honour an APA felt to have an adverse effect on Germany's tax base.

A further reason Lerat used to justify opposition to APAs was, in his words, that: "Effecting an advance pricing agreement amounts to asking the authorities for an advance ruling on a matter of fact - it is asking the tax authorities, taking into consideration the specific circumstances of the issue, if the transfer price in question is a good one. This is something the French tax authorities are not in a position to accept" (Swiss, 1995). This is a problem which has already been brought up in relation to the cancellation of an APA (see last page).

- Concluding Remarks

The advantages and disadvantages have now been discussed, but the extent to which each effects MNEs will be dependent on the individual countries, their APA process, experience and relationship to other nations. The next section investigates the US APA framework and their commitment to advance rulings as a solution to international transfer pricing.

US APA System

- Considerations Before Application

When considering entering into an agreement, a company must be aware of the demands the IRS will place on them, particularly with regards to information requirements. It has become

imperative, for example, that a company be ready for the tax investigation and exposure it will receive with regards to audit history and prospective future audits. An important objective should, therefore, be to limit the liabilities of such divulgence through, as proposed by Plambeck (1994), making sure the company construct its internal accounting procedure to comply with the applicable US and foreign countries rules.

A taxpayer needs to decide which transactions will benefit the most from APAs; perhaps those already subject to the most scrutiny from the IRS. Ryan and Patton (1991) suggest the following transactions be considered:

- a) *Distribution of finished goods* - The foreign affiliate acts as a marketer of products manufactured by the US entity. The taxpayer might propose a specified gross profit margin range for specific lines of products. The proposed transactions could also involve the distribution of product in the US produced by a foreign affiliate of foreign parent company.
- b) *Sales of Raw Materials or Components* - The APA could cover transactions between manufacturing sites that each use common components in the manufacturing process. Affiliates may trade components or raw materials among themselves to make up for shortages or surpluses. These transactions could be conducted on a predetermined cost-plus basis.
- c) *General and Administrative Expenses, Managerial Services* - The APA could cover G&A or management services. These services could be identified and compensated for on a strict cost or cost-plus basis.
- d) *Technical Services* - An APA could cover technical services rendered by foreign affiliates on behalf of or in connection with foreign marketing activities. A uniform basis could be agreed upon for the intercompany charge.

e) *Global Trading* - The IRS has indicated that it is interested in obtaining taxpayer comments regarding trading of currency and financial instruments. An article by an IRS attorney suggests that such transactions might be an appropriate subject for an APA.

f) *Cost Sharing Arrangements* - The APA could cover the computation of the buy-in, the amount and duration of any royalty for preexisting technology, the product coverage of the agreement and the affiliates covered by the agreement.

If products are similar enough then it may be possible for an agreement to be signed for more than one transaction. In addition, the company must decide on the transfer pricing methodology (TPM) which is acceptable under Section 482 regulations, for each cross-border exchange. This includes the provision of data to prove the TPMs are the 'best methods'.

Supplementary issues include considering the new reporting requirements which will be imposed on the taxpayer in creating an APA, proving compliance with the contract, and finally, whether the company will benefit from simultaneous APAs with more than one nation.

- Pre-Filing Conference

A taxpayer is given flexibility to request a pre-filing conference prior to the application of an APA. The aim of this meeting (or more likely a sequence of them) between the company and the Office of the Associate Chief Counsel (International), the main party in the IRS responsible for establishing APAs, is to informally discuss the prospect of an APA. Objectives of such a preliminary meeting may be, according to Rev. Proc. 96-53, to discuss the data, documentation and analyses that may be necessary; the need for an independent expert; the suitability of the chosen TPM; the possibility of an agreement among competent authorities; and IRS methods for scheduling, coordinating and evaluating such requests.

An independent expert's report is required under Section 5.02 of Rev. Proc. 91-22, and is to be compiled by specialists from each of the countries involved in the APA. Rev. Proc. 96-53 does not contain much detail on using these experts, merely mentioning it as a topic for discussion at the pre-filing stage. The value of such a report to the taxpayer is dependent on the belief that an independent's support for the formation of an APA will have the effect of lessening resistance to the request by the District Director's Office (International).

There have been a number of criticisms of the independent reports. In particular, the expense of such a report, which the taxpayer bears but is not guaranteed a result in his favour. In addition, as noted by Ryan and Patton (1991), the extent of independence of each report is likely to be limited. This is because any of the few real experts in transfer pricing are bound to have, at some time, had some involvement with the taxpayer, their representative or the IRS.

A company may, if they wish, participate anonymously in a pre-filing conference, however, representatives of the District Counsel Office, who have responsibility for the taxpayer's returns and who would normally partake, will have no information on the company and therefore will not be able to join in preliminary discussions. Anonymous involvement, therefore, will limit the information the IRS can say to the taxpayer with regards to specifics about their industry and the usefulness of such a conference.

- Apportionment Methodology

When a taxpayer has decided to go ahead with the application for an APA he is obliged to provide substantial information with respect to the TPM. According to Rev. Proc. 96-53: "The request should illustrate each proposed TPM by applying it, in a consistent format, to the prior

three taxable year's financial and tax data of the parties. When the TPM applies to a new product or business, the request should include an illustration based on projected or hypothetical data." This constitutes expensive documentation for the taxpayer to collate and attempt to present in a way biased towards the preferred TPM.

Once a TPM has been agreed upon, the IRS can continue to scrutinise the results, and although a single result may be challenged, the TPM cannot be changed, against the wishes of the taxpayer, by the IRS.

- General Factual and Legal Items for All Proposed TPMs

This section in Rev. Proc. 96-53 contains a list of the articles which must be included in each request for an APA. The following is a summary of this catalogue.

- (1) The organisations, trades, businesses, and transactions that will be subject to the APA.
- (2) The details of the controlled taxpayers that are parties to the intended APA.
- (3) A properly completed Form 2848 for any persons authorised to represent the parties in connection with the request.
- (4) A brief description of the general history of business operations, worldwide organisational structure, ownership, capitalisation, financial arrangements, principal businesses, and the places where such businesses are conducted, and major transaction flows of the parties.
- (5) Representative financial and tax data of the parties for the last three taxable years, together with other relevant data and documents in support of the proposed TPM.
- (6) The functional currency of each party and the currency in which payment between parties is made.
- (7) The taxable year of each party.
- (8) A description of significant financial accounting methods.

(9) An explanation of significant financial and tax accounting differences between the US and the foreign countries involved which could effect the TPM.

(10) A discussion of any relevant statutory provisions, tax treaties, court decisions, regulations, revenue rulings, or revenue procedures that relate to the proposed TPM.

(11) A statement describing all previous and current issues that relate to the proposed TPM.

- Specific Factual Items for a Proposed TPM Other Than a Cost Sharing Arrangement

This section contains information which might have some relevance in establishing that the requested TPM be in accordance with the ALP.

(1) Pertinent measurements of profitability and return on investment.

(2) A functional analysis of each party setting forth the economic activities performed, the assets employed, the economic costs incurred, and the risks assumed.

(3) An economic analysis or study of the general industry pricing practices and economic functions performed within the markets and geographical areas to be covered by the APA.

(4) A list of the taxpayer's competitors and a discussion of any uncontrolled transactions that may be comparable.

(5) A detailed presentation of the research efforts and criteria used to identify and select possible independent comparable and of the application of the criteria to the potential comparable.

(6) A detailed explanation of the selection and application of the factors used to adjust the activities of selected independent comparable for purposes of devising the proposed TPM.

- Specific Factual Items for a Cost Sharing Arrangement

APAs for intangibles are extremely rare, if indeed any exist. The complexity of forming such an APA is demonstrated by the length of the following list of the information, which may all be necessary to establish that the proposed agreement involved a cost sharing arrangement.

(1) The history of the business operation, the geographic locations, and principal business activities of each of the parties involved.

(2) Documentation of the arrangement and any changes made to it.

(3) The participants, their dates of entry, each participant's contribution, each participant's interest in any covered intangibles, and how each participant reasonably anticipates that it will derive benefits from the use of covered intangibles; a statement whether there has been or will be any transfer by any participant of covered intangibles to another taxpayer under common control and, if so, how benefits will be reflected under those circumstances; and evidence of participants' compliance with the reporting requirements under the cost sharing regulations.

(4) The method for calculating each participant's share of intangible development costs; and a statement whether and how the participant's shares of intangible development costs will be adjusted to account for changes in economic conditions.

(5) The scope of research and development to be undertaken.

(6) The duration of the arrangement; the conditions under which the arrangement may be modified or terminated; and the consequence of such modification or termination.

(7) The scope of intangible development costs, and which costs are included and which are excluded; a description of any services performed for participants and how those services would be taken into account; and, for a representative period, a breakdown of total costs incurred, and costs borne by each participant, pursuant to the arrangement.

(8) The basis used for measuring benefits, the projections used to estimate benefits, and why such basis and projections yield the most reliable estimate of reasonably anticipated benefits;

a description of any amounts to be received from nonparticipants for the use of covered intangibles and how such amounts would be taken into account; and, for a representative period, a comparison of projected and actual benefit shares.

(9) The accounting method used to determine the cost and benefits of the intangibles development, and to the extent that the accounting method differs materially from US generally accepted accounting principles, an explanation of any material differences.

(10) Prior research undertaken in the intangible development area; any tangible or intangible property made available for use in the arrangement and any compensation paid for that property; and any other information used to establish the value of preexisting and covered intangibles.

(11) Whether and how participants may join or leave the arrangement; any adjustments that will be made to the participants' interests in covered intangibles in such cases; any payments that must be made in such cases, and how such payments will be calculated and made; and whether any changes in the participants' interests in covered intangibles have already occurred, any compensation paid for those interests, and any information used to establish the value of such interests.

(12) How cost sharing payments and buy-in or buy-out payments made or received have been treated for US income tax purposes.

(13) Representative internal manuals, directives, guidelines, and similar documents prepared for purposes of implementing or operating the cost sharing arrangement.

(14) Each participant's gross and net profitability with regard to the product area covered by the arrangement.

- **Critical Assumptions**

It is also necessary for a taxpayer to describe what they perceive as a set of critical assumptions, incorporating those factors which, if they were to change, would effect the nature of the APA. Rev. Proc. 91-22 describes these as, "objective, business and economic criteria that are fundamental to the operation of the taxpayer's principal TPM". Rev. Proc. 96-53 suggests as examples: a particular mode of conducting business operations, a particular corporate or business structure or a range of expected business volume.

- **Annual Reports**

As part of the contract, the taxpayer agrees to provide annual reports demonstrating company compliance with the APA, in particular highlighting the appropriate application of the selected TPM. Additional items to be included in each report are: "A description of any tangible lack of conformity with critical assumptions; and an analysis of any compensating adjustments to be paid by one entity to the other, and the manner in which the payments are to be made" (Rev. Proc. 96-53).

When commenting on problems found with the annual reports of companies, Ryan and Patton (1991) said that there ought to be limited allowance for the District Director's Office to make adjustments to simple mistakes or oversights made by the taxpayer.

The annual report also acts as a channel through which the taxpayer can communicate requests to renew, modify or cancel the APA.

- Term and Timing

The taxpayer is responsible for suggesting the initial period for which they want their APA to last. The desire for an agreement to last for as long as possible, to avoid periodic renewal fees, must be balanced against the likelihood of the company experiencing considerable changes over time, with particular respect to the critical assumptions which would render an APA obsolete. The longer the period the greater the possible divergence for the original terms.

The actual start date is also at the taxpayer's discretion. It is possible to activate an agreement to apply from the beginning of a tax year in which the request is made for such a contract; although limited retroactivity is permissible, full retroactivity is sometimes provided for in the APA (Feinschreiber, 1992).

- User Fee

The US charges a taxpayer requesting an APA a sliding scale registration fee, dependent on the company's gross income. This payment is required as a demonstration of the taxpayer's good faith in pursuing a contract (Gould, 1997). Rev. Proc. 96-53 summarises the user fee provision on the following page.

Table 8.1

Taxpayer Gross Income	Original Request	Each Additional Multilateral Request (1)	Routine Renewal (2)	Small Transactions (3)
\$1 billion or more	\$25,000	\$7,500	\$7,500	\$7,500
Less than \$1 billion and greater than or equal to \$100 million	\$15,000	\$7,500	\$7,500	\$7,500
Less than \$100 million	\$5,000	\$5,000	\$5,000	\$5,000

US APA User Fees

- (1) Only if such additional request involves the same issues, covers the same years, and proposes the same TPM as the first request (as opposed to subsequent requests).
- (2) Only if the material facts, critical assumptions, and proposed TPM have not substantially changed.
- (3) Regardless of taxpayer size, applies to transactions that involve (i) tangible property or services valued at no more that \$50 million annually, or (ii) payments for intangible property not in excess of \$10 million annually.

- Processing of APA Requests

After the request has been received, the IRS reviews the information, asking any questions they have and requesting further documentation.

Upon receipt of the request, according to Rev. Proc. 96-53, the APA Director organises for the coordination of the request with other officials who may also have an interest, such as the District Director, Regional Director of Appeals, District Counsel and, where appropriate, with the US competent authority (CA). The APA Director is also responsible for appointing a team of officials for each request, with a leader to oversee the negotiations, one who had preferably,

been present at the pre-filing conference and, therefore, aware of the concerns and points addressed at that time by the taxpayer, and any informal agreements which may have been made during this initial contact.

The request will then be evaluated, through discussion with the taxpayer and examination of relevant data. A case plan and schedule would then be created, setting dates for the completion of different targets by the participants to the APA and the IRS. These will contain a list of questions raised in the initial stages and an itinerary organising the time plan for resolving them. The case plan and schedule will also be responsible for setting out the basis of the agreement between the taxpayer and Service personnel on the "scope and nature of any additional information that will be required to resolve these questions in order to negotiate an APA". 'Milestone dates' for completion of parts of the APA should also be included in the documents and which both parties must make a great effort to abide by and achieve. By mutual decision making, these milestones may be adapted to retain flexibility in the process. Consistent failure, however, on the part of the taxpayer can result in a withdrawal of the APA request.

- Concluding an APA

The conclusion, according to Plambeck (1994), is a memorandum of understanding between the governments and the taxpayer. Once this has been agreed, the taxpayer has the legal document drawn up, the APA, and the final act is the execution of this legal document.

- Revocation or Cancellation of an APA

Feinschreiber (1992) finds that the IRS will revoke an APA in the event of fraud, malfeasance, or disregard as to any of the following three factors: material facts set forth in the request;

subsequent submissions including in any annual report; or the lack of good faith compliance with the terms and conditions of the APA. As Ryan and Patton (1991) point out, however: "To obtain an APA it is unlikely that any taxpayer who is going to volunteer the extensive information required by both jurisdictions to obtain an APA will enter into this process either lightly or in a malevolent spirit." This being the case, the IRS can not expect to have to revoke many agreements.

With regards to the cancellation, any party is able to stop the negotiations at any stage, even after the start of the final agreement. If the IRS decides to cancel, the taxpayer should be able to attend discussions as to the reasons why, and in extreme cases can exercise the right to challenge the decision by going to Appeals or the Tax Court. Cancellation can result from a misrepresentation mistake, for example, and the procedure should permit the taxpayer the opportunity to make a correction first (Feinschreiber, 1992).

- Growth and Maturity of the Programme

The programme has continued to grow in popularity since its inception in 1991, and this can be put down to a number of factors. In particular, that this has all been possible as a result of the huge investment of resources committed by the US government, particularly during the Clinton administration, to assure that the process works and the integrity of the programme is high (Triplett, 1994). An example of this commitment was to change to the Section 482 regulations making them more relevant to APAs. This was achieved through the participation of APA staff in the formulation of the 1994 final regulations. Plambeck (1994) highlights the introduction of the best method rule as a beneficial example of this participation, with the TPM choice dependent of the value of comparable available data, industrial descriptions and

functional analysis. In addition, the regulations provide a framework to enable firms to assess whether they should enter into an APA.

The US APA process has not been without inevitable 'growing pains', which can be routed back to a number of places. Most critically was the popularity of the programme compared with the resources available. In 1994, Plambeck recorded the following results of participation:

1990-1994	46 cases completed.
1994	47 applications at pre-filing stage
1994	72 cases open
1994	Average rate of entrants at 15 per quarter.

A number of authors on the subject reported that the programme was almost full. Unfortunately, this can be interpreted as a variable slowing the speed in the completion of agreements, and with the IRS trying to encourage more entrants than it could reasonably expect to accommodate. The IRS, however, was quicker to blame the growing problems on the taxpayers, accusing them of not meeting the 'milestone' dates. It is difficult to set milestones, especially when taxpayers previously unaccustomed to APAs are unfamiliar with a number of the new requirements placed upon them, and can not anticipate the time required to collate this data.

Schwartz et al (1995), on the other hand, account the delay to two other factors. First, the change in the leadership of the programme at the IRS, however, the appointment of Michael Durst as director in 1994 came with an apparent renewed emphasis on the completion of more settlements and hence this disturbance was short lived. Secondly, the amount of time it takes when a company is looking to conclude an APA with more than one country, when competent authorities are involved and there is a requirement for an accordance on the TPM of

companies. As Schwartz et al (1995) pointed out, work is being done to develop broad guidelines for handling the CA portion of APAs. Although there are time delays and growing pains there is a conscious effort on the part of the IRS to minimise these disadvantages.

Additional efforts are being used towards maximising the organisational efficiencies of the process, resources are being expanded to meet the increasing demand for APAs and the authorities are looking to industries to develop generic descriptions to minimise the process time (Plambeck, 1994). Previous examination (see earlier chapters) of the problems of comparability between even apparently similar companies with like transactions demonstrates that to develop general descriptions for some of the basic features would be almost impossible in a majority of cases. Continual change in industries would require constant updating of generic descriptions. In addition, it would be impossible to guarantee that the companies, on which these generic descriptions were created, would develop in similar enough ways over time, rendering the depictions of the industry obsolete. On the other hand, however, Andrew Hickman, International Specialist and CA Specialist at the Inland Revenue, noted that specialist advisors, who are employed to develop methodology, may have a generic APA 'on the shelf' that could be adapted for each case, but that it is the adaption which is important not the generic nature.

The programme has matured since its inception in 1991 and continues to do so with the immense commitment on the part of the IRS. For many MNEs, a well proven and well defined APA system is increasingly preferred to the alternative of increasing audit attention from tax authorities.

To be able to compare the US experience of APAs it is necessary to examine the approaches of a number of other countries and their views on and commitment to such a system.

Different Countries Experiences with APAs

To be able to put the US experience of APAs into context it is necessary to examine the approaches of other countries. This final section charts the experiences general opinions of fourteen countries, listed alphabetically, with APAs.

- Australia

Australia was involved with the US and Apple Computer in the first ever APA and has continued to encourage the completion of similar agreements. The procedure is enshrined in a draft ruling released by the Australia Tax Office on July 14, 1994. According to the 1997 Ernst and Young Report, at least 9 APAs had been completed by that time, with 15% of all the Australian-based firms (including the firms interviewed who had not already completed an APA) having said they would consider the use of one in the future.

- Canada

Canada has embraced APAs to almost the same extent as the US, the main difference being the deliberate decision to create a less detailed procedure in order to encourage maximum participation. So far this objective has been achieved, with Ernst and Young's 1997 Report finding that 14% of the firms they interviewed had used APAs in the past and recorded a high level of satisfaction. The success of the programme could also be measured by the 50% of companies who would consider future use.

Canada started a formal APA programme in July 1995, subsequent to initiating two successful pilot programmes in 1991, a short while after the introduction of Revenue Procedure 91-22 in the US. One trial dealt with 'inbound' transactions and the other with 'outbound' transactions. After evaluation of these cases, Revenue Canada announced its intentions to introduce an APA service for determining transfer prices in selected cases in July 1993 (Ward and Armstrong, 1994). The responsibility of administration was given to the International Tax Programmes Directorate in Ottawa.

The achievement of an APA is guided by Information Circular 87-2, which, according to Ward and Armstrong (1994), provides an overview of the process and highlights the key provisions and requirements of the programme. The following, for example, is a list of the criteria which Revenue Canada will consider:

- whether the particular transfer pricing issues and problems outlined in the APA request are best dealt with through the APA process, and not through the normal audit process;
- whether the application of any APA would be ongoing in nature and have long-term implications. Although not stated in the draft circular, it is understood that the usual term for an APA will be three years, plus any renewal periods;
- whether the transactions to be covered include all related cross-border transactions between the applicant and the relevant foreign-based related entity;
- whether the transactions are prospective and not completed or near completion (Revenue Canada states that it will not consider applications for APAs for future transactions that are not seriously contemplated, or that are of a hypothetical nature);
- whether the applicant is one of a number of participants in a major industry, and conclusions reached under the particular APA request will have wider application to similar companies;

“ whether the other involved is a treaty partner, and it is favourably inclined to considering an APA request in entering into a bilateral APA (Ward and Armstrong, 1994).

With regards to creating a less detailed approach in comparison to the American approach, Canadian APAs are expected to be quite universal, encompassing all cross-border intercompany transactions, as opposed to a US-style APA per transaction. The result of the APA is a broad understanding and agreement of TPMs to be used and data required to support them and the critical assumptions, rather than specific agreement on prices (Coopers and Lybrand, 1995).

Like the Rev. Proc. 91-22, taxpayers are allowed pre-filing conferences with Revenue Canada to explore the suitability of an APA for them. Upon application, no fee is required, unlike in the US, but taxpayers must pay all costs for independent experts.

A further similarity to the US experience is the problem of funding the enormous resources to solve the transfer pricing problem and, as a result, it would be virtually impossible for Revenue Canada to provide an APA for everyone.

- China

China is not amongst the most experienced countries in the world of transfer pricing however, the authorities are starting to become more alert to the potential for transfer pricing abuses. Sherwood, Huang and Shum (1997) commented on the country's progress, "China is rapidly moving towards international standards in terms of settling controversies and disputes in the transfer pricing arena through APAs". This includes the completion of one such agreement involving both the US and China.

- France

The French appear to be most against the idea of APA. Swiss (1995) hinted that this is a reaction founded on the belief that the power and influence of the US will mean that somehow companies will end up agreeing to pay more tax in the US than France. Swiss (1995), therefore, was able to conclude that: "The French authorities are unlikely to recognise a transfer price fixed by the US tax authorities. There is thus no point in participating in such an advance pricing agreement programme." Ernst and Young (1997) substantiates this, finding only one French respondent to have actually used an APA, only 6 percent willing to consider the prospect and a significant 53 percent against the idea.

Consultations are currently being held among the French authorities to consider whether or not to introduce a system suitable for APAs are not likely to be successful if they mirror the views and results expressed above.

- Germany

Germany holds a similar opinion to the French, opting to watch progress elsewhere before committing itself. Although Ernst and Young (1997) found that 20 percent (14 percent), more than in France, would consider using an APA, a greater portion (60 percent), in comparison with France, said they would not consider using an APA.

Rehder (1996) offered the following warning to US firms with affiliated German companies: "If information shared with the IRS during the APA negotiations is not shared with German tax authorities, and those authorities determine that their tax base was not sufficiently considered during negotiations, companies can be quite certain that German authorities will review the APA with great scrutiny and possibly demand an adjustment and penalties."

- Italy

Ernst and Young (1997) reported the following on the Italian use of APAs: "Two respondents report having used an APA. However, since Italian law does not envisage APAs, it may be that Italy was not a party to the APA, or that less formal clearance procedures available are viewed as APA-type arrangements."

Ernst and Young recorded a negative attitude towards the use of APAs in the future, finding that 56% of those interviewed were not likely to use them. There was a totally different mood towards the EU Arbitration Convention with 76% saying they would consider using it, and furthermore, 53% would consider the use of bilateral CA procedures.

- Japan

Japan is another of the minority countries which supports the use of APAs; with the National Tax Administration Agency (NTA) actively encouraging taxpayers to apply for such agreements. Dealing with APAs is just one of the responsibilities of the Director of International Tax, who also deals with CA negotiations and other double taxation issues.

Currently, Ernst and Young (1997) found that 2% of interviewees had used an APA previous to the report and that 24% would consider use at some point in the future.

The Japanese refer to an APA, however, as a pre-confirmation agreement and it is not legally binding. This system has been in place since 1987. According to Yoost and Miyajima (1997), the requirements include information: "about the taxpayer's overseas affiliates, including the volume and value of related-party transactions, the terms and conditions of the transactions, market conditions, and an explanation of why the selected transfer pricing methods are the

most appropriate. A functional and risk analysis, and profit split calculations generally are required."

The NTA discourages the application for unilateral agreements unless there is good reason for not securing bilateral or multilateral agreements. This can be demonstrated by the 32 multilateral pre-confirmation applications pending out of a total of 42 in September 1997. Yoost and Miyajima (1997) noted that in 1995 Apple Computer Inc. was the first foreign-owned company to acquire a multilateral pricing agreement, followed by JP Morgan.

Yoost and Miyajima (1997) warn taxpayers about the future of the pre-confirmation system and the proposal to introduce the procedure into tax law: "Some practitioners believe the proposed legislation could be an effort to prepare for eventually requiring all taxpayers with transfer pricing issues to enter into agreements with the Japanese tax authorities."

- Korea

In 1995, Korea's National Assembly passed the Law for the Coordination of International Tax Affairs (LCITA) to establish new rules with regards to international transfer pricing. Under the LCITA the National Tax Administration (NTSA) could issue APAs to take effect after January 1, 1997. The Law's Enforcement Decree, passed by the Ministry of Finance and Economy at the end of 1995, lists the details regarding the application, screening procedure, notification procedures, reporting requirements, and legal ramifications of such APAs (Kim, 1997). The Decree also provides for cooperation with foreign competent authorities where appropriate.

Kim (1997) wrote that the NTA is required to consider opinions from regional and district offices on APAs to ensure field inspectors' input into the APA proceedings. Given the relatively new inception of the programme, it is unsurprising that only a few applications have been made; however, the idea has been welcomed, with Ernst and Young (1997) having reported that 34 percent of MNEs investigated would consider using the procedure.

- Mexico

Mexico supports the use of APAs, and in 1995 Schwartz et al (1995) reported that the: "Mexican tax authorities are currently considering eight requests for APAs. This includes one trilateral APA involving all three North American Free Trade Agreement (Nafta) jurisdictions. The Mexican Department of Finance and Public Credit is currently developing its own formal APA ruling procedure."

- Netherlands

The Netherlands allow a number of advance rulings to control the problem of transfer pricing, all of which are applicable to a four year period, beginning on the day the Dutch ruling activities are initiated. Thereafter, agreements can be extended for a maximum of four additional accounting periods. An article by Groenen and Spierendonk (1994) contains information on the general terms for specific types of transactions. In dealing with other governments, the Dutch authorities rely on their treaties, largely based on the 1977 OECD Model Treaty on associated enterprises..

Ernst and Young (1997a) reported that the number of companies who had used APAs in the past (25 percent) was the highest proportion amongst the countries involved. Despite this, only 38 percent were actually found who would consider using one at a later date. Perhaps

Only 11% of those interviewed by Ernst and Young (1997) would consider the use of an APA in the future. The bilateral CA procedure appeared more popular, with 44% who would consider its use in the future.

- Switzerland

According to Ernst and Young (1997): "Four Swiss parents report having used an APA in the past. Only 20 percent of Swiss respondents would consider using an APA in the future, while 55 percent would not. Swiss MNEs resort to bilateral CA procedures less frequently than any other country's respondents."

Unlike Sweden, Switzerland permits the use of APAs and Ernst and Young (1997) said that they are treated in a manner comparable to an anticipated CA claim.

- UK

Until recently the UK has been relatively 'lukewarm' regarding APAs. In an article in *Management Today* in 1995 John Hobster, then of the Inland Revenue's International Division now a Partner with Ernst and Young, suggested that "the case for extending APAs outside of the financial services sector is not, we feel proven". However, the issue of consultative document, "Modernisation of Transfer Pricing Legislation", (Inland Revenue, 1997c) marked a change in this position. The Inland Revenue invited views in this Consultative Document (ConDoc) on whether there should be a wider role for APAs to play (Appendix 7). The response (Inland Revenue, 1998a) showed a high level of support and, as a result, a statutory procedure for their use in the UK is to be introduced in the 1999 Finance Bill Budget (Inland Revenue, 1998c). To help achieve this, and to make the process work in practice, the

this is an indication of the dissatisfaction with the APA process as it currently stands, or that the Netherlands have experienced 'growing pains' similarly experienced earlier in the US and which severely lengthened the process and increased the cost of participation.

- Spain

Spain is new to APAs and has only recently introduced a provision allowing them into legislation. Calleja (1997) noted the following, which differentiates a Spanish APA from any other: "Article 16 of the Corporate Income Tax Law reduces the APA concept to the possibility, available to the taxpayer, of submitting for approval by the tax authorities a proposal for the valuation of related-party transactions. The law, however, does not clearly treat APAs as the result of genuine negotiations between the two parties." A taxpayer does have contact with their relevant tax inspection authorities to discuss for example, the TPMs and level of documentation necessary. If these discussions have been detailed enough a taxpayer's proposal should not end up being rejected.

To conclude, Calleja (1997) noted that: "APAs in Spain take the form of an approval by the authorities, rather than an actual agreement between taxpayer and tax administration. In this respect the success and effectiveness of the figure will largely depend on the adoption by the authorities of a practical and truly negotiated approach in the application of the law."

- Sweden

Ernst and Young's 1997 transfer pricing report found that: "Under a government directive, a legislative working group was to be established in 1997 to review the current legislation on transfer pricing." It was understood that this might review the use of APAs which was not previously mentioned in legislation.

Chancellor, has authorised the Inland Revenue to enter into consultations with taxpayers to discuss the details of the new arrangements.

The Ernst and Young 1997 Report recorded that 25% of the UK respondents interviewed had used an APA in the past and 68% indicated they would not, at present, expect to consider an APA in the future. The APAs formed would have been carried out with the agreement of the Inland Revenue and under the powers of the mutual agreement procedure, granted under the terms of Double Taxation Conventions, to participate in APAs with tax authorities which have introduced legislation enabling them to create APAs. This has involved the Inland Revenue engaging in bilateral negotiations with other relevant tax administrations. The consultative document recognises that the consequences of such dealings are that the arrangements tend to be geared towards the formal procedures established by the other involved jurisdictions. Dissatisfaction for such a process can be seen; firstly, by not even letting firms situated in countries which do not have treaties with the UK enter into any such arrangements; and secondly, where countries are linked by treaty, the mutual agreement procedure has been responsible for causing a number of time delays. KPMG report they were aware of 25 APAs involving the UK at present.

At present the UK APA process is not clearly understood currently, and this has acted as a major deterrent for taxpayers considering its use. Ernst and Young (1998) suggested that: "A demystification of the process, possibly through the publication of a set of procedural guidelines, results and case histories could possibly expand the demand for APAs but unless the procedure is open to every UK taxpayer, the process will remain of limited value." In addition, many taxpayers are dubious as to the specific advantages and disadvantages to them, which prevents accurate decision making and planning with regards to APAs.

The cost of obtaining an APA is one of the disadvantages. Ernst and Young (1998b) conclude that the high cost of an APA would mean the process will only hold value where either a taxpayer has significant transfer pricing issues which are almost certainly going to attract attention from a Fiscal Authority at some point, or where the certainty of tax treatment is crucial, for example in the case of a single but very large prospective transaction.

Coopers and Lybrand (1991) make reference to the cost of an APA process relating to this time factor. They say that although the Inland Revenue may be constrained by other tax authorities when dealing with multilateral APAs, it should ensure that the Inland Revenue do not create the same restraints and that unilateral APAs are available within a reasonable time frame. The US and Canada both started out with APAs taking over a year to complete. UK firms may not be willing to suffer the same, specially when the transfer pricing regulations have not been framed and are not believed to be enforced as strictly in the UK as other countries.

With regards to unilateral APAs, there appeared to be a demand from companies for regulations to exist to establish them in UK law. Support was particularly strong for circumstances where Agreements involve non-treaty countries or where the other country has yet to establish any sort of formal APA procedure or where APAs were not so clearly supported by other Fiscal Authorities, for example France and Germany at present. This would, in effect, reflect the formal situation in the UK prior to March 1998. Furthermore, this type of agreement is often simpler and quicker to establish, compared to the bilateral and multilateral agreements. As the tax treaty network expands, and with more countries adopting an approach based more and more on APAs, the demand for unilateral agreements should fall,

but the response to the ConDoc (Inland Revenue, 1997b) clearly suggested that the need is enough at present to warrant its introduction.

A further clear message from the responses to the ConDoc was that it would be unfortunate if the current informal 'advanced agreements' were lost as a more formal APA system was established. It appears to be the Revenue's aim to continue to allow informal approaches (without fees at present) ahead of any formal APA or other submission to the International Division. This continues to be considered a 'good use of resources' by the International Division.

In general the demand for a clearly defined APA procedure is a positive step towards solving the problems of transfer pricing, but the question remains as to how much will the Inland Revenue be in a position to create the legislation and guidance taxpayers need to make viable decisions concerning entering into APAs.

Conclusion

This chapter has explored the advantages and disadvantages of APAs and it can be seen that this is an idea which will be no means be the panacea to transfer pricing disputes around the world. The relatively small demand for such arrangements demonstrates that companies are obviously aware of that fact. APAs do help those firms who are experiencing a lot attention on their transfer pricing practices from tax authorities and probably having to make a lot of adjustments. As tax authorities are observing the cross-border transactions more and more

CHAPTER 9.

DOUBLE TAXATION RELIEF

DOUBLE TAXATION RELIEF

When the complexity of the law and the sophistication of financial transactions are coupled with technological change in both commerce and tax administration, the combined impact on tax compliance, administration and enforcement is phenomenal (Peterson, 1994). Co-ordinating the approaches towards international transfer pricing of governments world-wide is an almost impossible task and where the relevant regulations are not complementary MNEs can expect some level of double taxation. This chapter is concerned with how double taxation arises and some of the legislative approaches adopted by governments.

- Territoriality and Residency

A multinational company, with operations in a country outside its home will be subjected to taxation by that country, on any profits recorded by the subsidiary located there. This is in accordance with the 'territoriality' or 'source' criterion, the taxation of profits in the country where they originate. When a subsidiary consigns dividends from these profits back to the parent company, the host country is likely to impose a withholding tax on these outgoing dividends. Withholding taxes can also be applied to interest, royalties and management fees.

According to Wagner (1998), withholding taxes can trigger double taxation in two ways: firstly, business income that is required to a parent is taxed first at business income tax rates and then again on the payment of the dividend; and secondly, all payments subject to withholding taxes are also subject to regular income tax in the country of the recipient. Plasschaert (1979) noted that a number of host countries will discriminate against intra-corporate dividends paid to foreign parent companies and tax them more heavily than dividends remitted to domestic parent

companies. Alternatively some countries will implement restrictions on the level of dividends repatriated. Plasschaert (1994) noted that the Andean group operated one such system. This clique of Latin American countries fixed the allowed dividend pay-out from subsidiaries back cross-border to their parent companies to 14 % of the net capital value.

It is also important to note the taxation 'rights' of the home country of a multinational corporation according to the 'residence' principle. This rule believes the location of a company's headquarters has some entitlement to the subsidiary's profits because the headquarters will contribute to the world-wide profit of the company. The result of concurrent claims by jurisdictions on the same profits is double taxation. A company being taxed on the same profits by two different authorities could, in the severest example, entail payment of more tax than the actual profit earned.

- Effect on International Trade

Double taxation interferes with international trade, making profits more tax-costly to attain abroad, discouraging firms from expanding their activities into other countries. An example of this interference comes from Johnstone (1998) who quoted a European Commission official: "Experience shows that reducing withholding taxes can lead to a substantial increase in foreign investment." It is an issue currently at the forefront of many multinational corporations concerns and effects their decisions towards carrying out business on a global scale. In the Ernst and Young Transfer Pricing 1997 Global Survey, it was found that 88 percent of the companies interviewed world-wide believed that the single most important international tax issue was double tax relief.

According to Simon (1997): "The ideal situation would be one in which there was neutrality both between the tax burdens of a person trading at home and abroad and between a resident and a non-resident trading in the same country. Until, however, there is one tax system common to all countries it will be impossible to achieve both these objectives." Unfortunately tax harmonisation is a long way off, so businesses must satisfy themselves with two types of relief measures to alleviate international double taxation. Firstly governments offer a number of unilateral options such as the use of foreign tax credits and secondly, governments partake in bilateral tax treaties which attempt to eliminate dual claims on profits. The following sections will examine both possibilities.

Unilateral Relief

- Foreign Tax Credit

One method of unilateral relief, which is offered by a large number of countries including the US, the UK, Germany and Japan, is a system based on foreign tax credits (FTCs). An FTC acts as a direct reduction on the tax levied by the country (offering relief) and the amount of credit allowed will normally be the lesser of the foreign tax paid (including withholding taxes on payments received from abroad) and the domestic taxes owed on foreign income. The result is a payment of taxes in both countries totalling the tax that would be paid at the highest rate of the two countries involved.

The UK first introduced unilateral relief in the form of a tax credit in 1950. Simon (1997) said that: "At first the credit was to be for three quarters of Commonwealth taxes and half of foreign taxes. This may have been because of the notion of imperial preference or because to give full

credit unilaterally would weaken the hand of the UK negotiators as they worked towards a full set of bilateral arrangements." These limits were removed shortly afterwards in 1953. Today the system of tax credits is formalised in the UK in Section 790 of the 1988 Income and Corporation Tax Act (ICTA). Credits can be used when the UK does not have a treaty with the country involved or when the tax in question is not included in the treaty.

In the case of dividends "underlying" taxes paid on business income by the subsidiary might be eligible for a foreign tax credit, depending on the country (Wagner, 1998). In the US this is permitted under Section 902(a)(IRC) and in the UK the relief is facilitated in Section 790(5)(ICTA), and governed by Sections 800 and 801(ICTA), as long as the US or UK owned corporation has at least a 10 percent ownership in the foreign corporation in question.

The FTC mechanism is extremely complex and not easily facilitated in the US because of Section 904(a)(IRC) which requires the determination of an FTC limited to the Federal income tax that would otherwise be due on the US taxpayer's foreign income (Benson, 1996). Furthermore, the establishment of the FTC limitation in the US under Section 964(IRC) is calculated using US tax accounting principles and not the amounts stated in the foreign accounts of the corporation in question. Benson (1996) also said that: "Certain US-incurred expenses must be allocated against foreign taxable income for this purpose. Thus, the effective foreign tax rate will almost always be different from (and is frequently higher than) the foreign statutory rate, making it potentially more difficult in many cases to fully use FTCs."

When a taxpayer has excess FTC's in the US, Section 904(c)(IRC) allows taxpayers to carry these residual credits and apply them to tax on that source for periods up to two years previously or forward five years. This is not permitted in the UK.

The use of FTC'S are restricted in a number of countries. Simon(1997) reasoned with the UK's reluctance to FTC'S: "There is of course no reason why the UK's Revenue should refund tax collected by another country, unless to encourage exports and for this there may be more efficient methods."

- Treat Tax as a Business Expense

An alternative option to a system of FTCs is to treat the foreign tax paid as another business expense and deduct it for computing the profits of the business. In the UK this is permitted by ICTA 1988, although it excludes the deduction of any foreign tax paid with respect to income charged on a remittance (paying back) basis.

- Exemption Method

Another mechanism for relief could be simply for tax authorities to not lay a claim on any profit companies earn outside their home territory, rendering a credit mechanism futile. This 'exemption' method has been used in the Netherlands, Canada and in the UK until 1974. According to Plasschaert (1979) using this 'exemption method' results in a lower burden on foreign direct investments than on domestic investments, provided the tax rate in the home country exceeds that in the host country.

Double Taxation Treaties

Bilateral relief is offered with a double taxation treaty, an agreement between countries to discuss the issue of double taxation when the problem arises for companies. As well as protecting against double taxation, the Inland Revenue (1997a) points out that the treaties also

aim to provide certainty of treatment for cross-border economic activity and prevent fiscal discrimination against a company's business interests abroad. Treaties act to override domestic law and will place some limitation on one country's rights to tax a resident of another country. Most countries, developed or otherwise, will have a network of tax treaties. Bilateral treaties are most common although some multilateral treaties may be found in Africa and in the Nordic countries (Simon, 1997).

- Model Tax Treaties

The US framework for participation in bilateral tax treaties is the Treasury Department's Model Income Tax Treaty of June 16, 1981. In general, however, most treaties, including those involving the UK, will have followed the structure laid down in the successive 1946, 1963 and 1977 OECD Model Tax Treaties (Appendix 8). In March 1998 the OECD said: "There are over 225 treaties between OECD member countries and over 1,400 world-wide which are based on the Model, and it has considerable influence on the bilateral treaties between non-member countries. Simon (1997) remarked of the OECD Model Treaty that it: "Has been criticised for its bias in favour of the country of residence over the country of source. This bias may have been acceptable to West European governments anxious for foreign, particularly American, involvement but has caused great difficulties for less developed countries." The OECD Committee, however, participated with experts of the United Nations Economic and Social Council in the development of a model convention specifically designed for treaties between developed and less developed countries. In 1988 the UN published this model treaty.

One particular problem with tax treaties among different jurisdictions is that, ultimately, because of the language differences agreements are not interpreted in exactly the same way. In addition, Zach (1993) commented on agreements with many developing countries and made the complaint

that, "in the effort to maximise tax revenues realised from foreign investment, they are inclined to comply with the letter, but not the spirit of tax treaties". Another problem largely applicable to developing countries, is that as the financial system of the countries change so the treaties, if not regularly updated, become outmoded. On the other hand, the speed and regularity with which most developed countries maintain relevant up to date treaties with their partners, however, limits the likely number of obsolete treaties to those formed between developing countries. Outdated or not, Knight and Knight (1997) pointed out that you can tell a country's interpretation of a treaty by the actual practice of the treaty signatories because "their conduct generally indicates their understanding of the agreement".

The OECD tries to minimise any problems countries may face with their Model Tax Treaty, through the establishment of a Working Party which regularly makes contact with OECD member and non-member countries and reviews the application of the treaty (OECD, 1998b).

- Competent Authority Procedure

Most bilateral treaties contain instructions by which a taxpayer can seek relief from double taxation using the competent authority (CA) procedure. The earliest availability of such a procedure was in 1970 and it was offered in the US. The process involves CAs exchanging information on the company in question and attempting to reach a suitable resolution through mutual agreement. This procedure is described and authorised by Article 25 of the OECD Model Tax Convention. Knight and Knight (1997) described the role of the CAs as having been given the authority to interpret the implementation of the treaties to achieve the effect of eliminating double taxation. The deletion of double taxation will involve a reallocation of income and a correlative adjustment. In addition, the CAs must inform each other of any changes made to their

domestic laws because an alteration could bring about double taxation for companies operating in both.

The CAs may be used by taxpayers to help elucidate their residency status and hence how they will be classed with regards to corporation taxation. For the purpose of this section, however, we will be concerned solely with the role of the CA towards the elimination of double taxation.

The CAs of different countries will have varying relations with their local tax inspectors. In the US, for example, there is a gap between their CA staff and audit staff and this created tension as the former, when they have made decisions, must persuade local staff to adjust. The UK situation, on the other hand, is different because there already existed a system whereby local tax inspectors were used to approaching the International Division for direction on decisions, thereby creating a situation where both parties were very familiar with one another.

As far as the legal courts of the countries are involved, they are ordinarily unwilling to intervene in the mutual agreement process and unlikely to interfere with the final adjudication of the CAs whether the outcome involves the entire elimination of double taxation or not. If there is a tax lawsuit already pending, however, then there will be a number of circumstances in which a CA may be requested and, in the case of a petition for relief from an adjustment, the outcome should be co-ordinated with the court official and the CA. In the US this former would be the district director from whom the relief would have been asked.

Taxpayers must make sure they comply with the requirements contained in the relevant treaties with regards to seeking CA relief and must request help, according to the US and OECD Model Treaties, within three years of first finding out that an action would result in double taxation. In

the US, with the updating of the CA process, taxpayers must also comply with the requirements of two additional Revenue Procedures, 96-13 and 96-14, when asking for assistance (Knight and Knight, 1997). These procedures, taken from Knight and Knight (1997), are summarised below.

- Rev. Proc. 96-13

Clarification of Residency Applicability - CA assistance may be available for taxpayers seeking to establish their residency status in the US.

Limitation on Benefits - Details requirements that must be met to qualify as a resident eligible for benefits under the treaty.

Time for Filing - In a US initiated adjustment, taxpayer can ask for CA assistance as soon as aware of amount of adjustment or in a foreign initiated adjustment, as soon as can establish probability of double taxation.

Prefiling Conference - Can be requested at any time to discuss any issues relating to a treaty.

Small Case Procedures - Taxpayer can file abbreviated request form for CA assistance if a proposed adjustment is not greater than: \$100,000 for an individual taxpayer; or \$200,000 for a corporation or any other.

Co-ordination with Appeals - Taxpayers can choose to (1) bypass appeals and request CA assistance immediately or (2) select a new simultaneous appeals procedure, under which the taxpayer or US CA requests that the issues be considered at the same time by both appeals and the US CA.

Co-ordination with Litigation - US CA must obtain the consent of the IRS Chief Counsel before accepting a request for assistance in a case pending in court or designed for litigation.

Accelerated Competent Authority Procedure - Taxpayers who engage the CA on one issue may request resolution of the same issue for subsequent periods. A request for such action can be made so long as the controversy has not already been resolved for the initial requested period.

According to Wrappe (1997): "The request should state that the taxpayer agrees that inspection of records under the procedure will not impede a later examination for any period covered in the request, and the IRS need not comply with any procedural restrictions before beginning such examination or inspection. If agreed, the US CA will present the request to the foreign CA.

Protective Measures - Taxpayers may need to take protective measures to make sure any agreements made by CAs are not barred by administrative, legal or procedural barriers.

- Rev. Proc. 96-14

This procedure sets forth procedures for requesting CA assistance when a tax case is pending in a US court or has been designated for litigation. The procedure provides that relief under Rev. Proc. 65-17 can be requested from the appropriate district director, rather than the US CA. Rev. Proc. 65-17 sets forth procedures to obtain an adjustment when a taxpayer's taxable income is increased because of an allocation of income between related US and foreign corporations under IRC 482.

As a concluding note on CAs, Deloitte Touche Tohmatsu International (1998b) said: "To a multinational enterprise exposed to double taxation, a well-constructed competent authority request can mean the difference between a highly favourable settlement and a slow, expensive process that produces an unsatisfactory result."

- Problem of Not Reaching a Conclusion

One of the problems with the competent authority procedure is the lack of any formal requirement to reach a solution. OECD (1995) noted that the competent authorities may be unable to come to an agreement because of conflicting domestic laws or restrictions imposed by domestic laws on the tax administration's power of compromise. If two competent authorities

fail to agree they have the option to leave the problem as it stands and let the company ultimately suffer the consequences of international business. When interviewing Andrew Hickman (1998), Competent Authority Specialist at the Inland Revenue (1998), he remarked that although it is difficult to reach acceptable agreements with other jurisdictions, that is not the most important factor to the Inland Revenue. He said that the International Division would be more concerned that the arm's length principle was being applied properly, which supposedly demonstrates a willingness to offer foreign tax credits if it means they are going to be more happy with a company's application of the ALP rather than compromising to reach an agreement.

The concern of companies over the non-resolution, by competent authorities, of double taxation is shown, according to Andrew Hickman (1998), in the relatively marginal execution of the mutual agreement procedure compared to the actual occasions of double taxation. In response to this, however, Chris Rolfe (1998), International Tax Partner at Coopers and Lybrand (London), said that the increasing number of disputes there are around the world has forced companies to make more use of the competent authority process. He continued to say that if you asked any multinational companies if they had used the mutual agreement procedure and if they intended to then the answer would almost certainly be that no one had used it and no one intended to. Now the transfer pricing audits are becoming ever more rigorous and the documentation demands ever more difficult to comply with that, according to Chris Rolfe (1998): "they (taxpayers) know perfectly well that they are going to end up settling in some countries and if they don't put some faith in the mutual agreement procedure there really is going to be double taxation here." If that faith is met with encouraging outcomes then the process will certainly be invoked in the increasing cases of double taxation.

Some companies alternative opt to absorb the double taxation. Reasons for this include a preference not to declare any adjustments suffered to the other jurisdictions and a belief that the actual resultant time and cost of the CA procedure would not justify the amount of double taxation saved.

Although taxpayers are not helped by the courts, as we have said already that they are averse to intervention on the decisions and battles of the competent authorities, taxpayers are aided by the recent introduction of the European Arbitration Convention and a number of alternative mechanisms for dispute resolution. Some treaties now contain provisions to allow companies to pursue further help and mediation.

- Timely and Expensive

"A company will have to go via a competent authority claim through the treaty and a competent authority claim is time consuming and an expensive way of approaching the double taxation problem" (Dykes, 1998).

It is actually very difficult to measure the average time spent on a case, depends what point one could begin timing from and when in the taxpayers' (tax) year they make the claim. It depends very much on the response time between the different competent authorities. Andrew Hickman (1998) remarked that when the Inland Revenue writes to the IRS it is going to be the first time they know of the issue. The company has, therefore, not simultaneously contacted the competent authorities with the problem, which might have speeded up the process since both parties would have begun at the same time to collect information and create their own negotiating positions.

Most of the activity involving the Inland Revenue trying to resolve over-taxation also involves the IRS. This is a reflection of the trade flows. The regularity of the communication between these two bodies and the good relationship created as a result is evidenced in the faster than average speed with which most of the double taxation is eliminated. Andrew Hickman (1998) estimated an average time of two years spent on such cases. He also pointed out the importance of physically meeting one another, the use of video link ups and regular conversations over the phone in the resolution process are important in maintaining that good relationship. As trade increases and other countries' competent authorities begin to meet more regularly they too will have such UK/US relationships, understand and appreciate the approaches of one another and the demands expected and this will contribute to the decreasing of time needed per case. A good rapport between competent authorities might result in more cases being solved, as they understand one another's points of view on matters, but that is not to say the conclusion reached will be one which the taxpayer desired. The latter could end up paying more tax in the jurisdiction that they did not originally want to.

In addition, the number of transfer pricing disputes on a bi- and multilateral scale is increasing and the competent authorities are demanding more and more resources to cope with the work created. Andrew Hickman commented that there are currently lots of adjustments being done and therefore plenty of work for the International Division to do in this area. Andrew Hickman and Daniel O'Marney, however, are the two UK people really responsible for the transfer pricing competent authority procedure and as a major trading nation does the UK really have enough resources to cope with the amount of work necessary to deal with the cases of double taxation?

Dykes (1998) agreed with Peterson (1994) about the slowness of the procedure and also added that it was considered an inflexible process. Peterson (1994) did say, however, that the

streamlining of the operations of the US process by the IRS Assistant Commissioner in 1993/4 has made significant improvements decreasing the previous average amount of time required to process a case by more than 50 percent. Currently the time needed will have decreased by even more than that.

With regards to the cost of the competent authority procedure there are in theory minimal additional costs for a taxpayer, since all the information that the competent authority would demand from a company should already have been created in keeping with the OECD and US transfer pricing rules adapted by at least most of the developed countries. The countries usually bear the costs of negotiation as opposed to the taxpayer paying for their services. In comparison there are a great deal more expenses for a taxpayer involved in obtaining an APA.

- Updating and Negotiation of Treaties

One bilateral treaty which warrants mentioning is the US/Portugal treaty, an agreement which amazingly took over 30 years to negotiate (Ioannou, 1995). Of course this is an exceptional case, most treaties take much quicker than that to reach agreement and are regularly updated to keep them relevant to the different countries participating. The OECD (1996) recommended that member countries: "Undertake promptly bilateral or multilateral consultations to address problems connected with tax treaty provisions, whether arising in their own country or raised by countries with which they have treaties

Two press releases issued by the Inland Revenue in October 1997 and December 1997 highlight the UK's constant updating and negotiation of new treaties. The former press release announced the achievement of concluding 100 treaties as of September 1997, the first country to reach this many agreements. In addition, the UK showed continuing commitment to treaties having held

negotiations since April 1996 with 23 countries, some of which were exploratory, including those talks with Kazakhstan, Lithuania and Namibia. Dawn Primarolo MP (Inland Revenue, 1997b), Financial Secretary to the Treasury, echoed this opinion in a December press release saying, "I want to confirm the Government's commitment to maintaining and to extending the UK's lead in the area of Double Taxation Agreements."

- Changing Treaties

Treaties are updated and changed through a process of renegotiation and to enable this to be done regularly an end date for treaties is usually included in the agreement, a point whereby the treaties are no longer 'valid'. It has already been said that competent authorities must tell other authorities of changes to their domestic laws, but it is also necessary that treaties be renegotiated if critical assumptions change from a result of statutory modification.

- UK Treaty Relief

The UK has the greatest network of double taxation treaties, holding agreements with more than 100 countries. According to Simon's Tax Cases (1997), the US has treaties with nearly all Western European countries with most members of the Commonwealth and with countries such as Japan and Israel. Countries who do not participate include many of the Arab countries and tax havens, although some agreements exist with the latter countries these are limited to arrangements involving transport profits and employees.

- Exchange of Information

Bilateral treaties, as well as providing a mechanism through which the problem of double taxation is resolved, they help governments counter tax avoidance and evasion by providing for the exchange of information between treaty partners. This means that additional financial

information, normally out of reach (over the border) from one authority, may be gathered and used for administering their domestic tax laws. In the US this is provided in Article 26 of the US Model Income Tax Treaty. Article 26 offers eight different ways in which information may be exchanged including, amongst others, a routine exchange programme and a simultaneous criminal investigation programme.

Arbitration Convention

Unresolved double taxation cases may have recourse to arbitration, although such procedures are new and not universally accepted by all OECD countries. In Europe the EU Arbitration Convention was signed by the 12 member states of the European Union on 23 July 1990 and came into force on 1 January 1995. The Convention was signed initially for a 5 year 'experimental' period but has not been extended for a further five years. According to Simon (1997): "This should do something to assist the taxpayer who finds himself as a shuttlecock batted across from one country's competent authority to the other."

The first stage of the proceedings under the convention is the same as the above, with competent authorities attempting to reach a solution through mutual agreement. If an agreement is not arrived at within two years from the date on which the case was first presented by one of the competent authorities, then the taxpayer has the right to have his case decided by a specially set up Advisory Commission. In a sense, the convention provides a better alternative for taxpayers because, at the final stage, proceedings under the convention produce a ruling which is binding

on the member states involved, unless the countries decide not to follow the recommendations and instead agree to eliminate the double taxation by some other means.

According to the Arbitration Convention, the advisory commission should consist of:

- Two representatives of each competent authority concerned;
- An even number of independent persons of standing;
- A Chairman - to be appointed by the independent persons of standing and must possess the qualifications required for appointment to the highest judicial offices in his country or be a jurisconsult of recognised competence.

The commission has the authority to demand any information, evidence or documents be provided by the enterprises and the competent authorities. This information is strictly confidential and if anyone from the commission divulges any information provided to him then he can expect to face prosecution.

The advisory commission must present its resolve, found by majority vote, within six months of the case being presented, a relatively short time scale which must be attractive to taxpayers. In addition, the cost is born by the jurisdictions involved and hence the taxpayer also benefits by not bearing any of the costs incurred.

Experience of implementing the provisions of the convention has been negligible. It is possible that, in future, there may be increased recourse to the convention following the changes in UK domestic law envisaged in the Modernisation of Transfer Pricing Legislation consultative document. With the requirement for taxpayers to give more information about inter-related transactions there is likely to be an increase in transfer pricing adjustments. It would seem

sensible for affected taxpayers to consider whether to invoke the convention either instead of, or as well as, the mutual agreement procedure article of a double tax treaty if they need to take steps to avoid double taxation.

The US also offers an arbitration service which was also passed in 1990 and is contained in Rule 124. According to Wrappe (1997), Rule 124 both encourages the use of arbitration and standardises the basic procedure for choosing arbitration. The most famous case is that of Apple Computer and was the only transfer pricing case to be brought to arbitration. The panel rules in favour of the IRS after much changing in the IRS position.

Conclusion

The most popular way of approaching the problem of double taxation is through the establishment and maintenance of tax treaties. Opening these lines of communication for tax authorities in different jurisdictions facilitates the discussion of the issue of taxation on MNEs operating across their borders and broadens awareness of the global operations of companies. the Arbitration Convention is really a "last resort" mechanism through which MNEs and tax authorities can discuss the issue of taxation if the MNE is seriously unhappy with the outcomes and taxation decisions of tax authorities.

CONCLUSION

MNE growth has resulted in a rapid increase in the total value of ITP transactions and tax authorities have realised the level of potential lost tax revenue. In 1992 in the US, Bucks and Mazerov (1993) reported that, President Clinton announced the federal government's annual loss of at least \$10-12 billion in tax revenues.

ITP effects almost every aspect of multinational operations including research and design, marketing and distribution as well as the global tax burden (Ernst and Young, 1997a). Numerous studies were carried out to determine the primary objectives of MNEs towards valuing ITPs to determine which aspects of global operations were most influential.

Governments suspected the sole objective of MNEs was to minimise global taxation. Tax minimisation is a major factor in the ability to maximise global profits, but Leith and Barrett (1992) said: "It is only one of the many components that follow from ownership, location, and internationalisation advantages that arise from market imperfections."

Studies reported similar findings that MNEs aimed to maximise their overall, world-wide profit and to achieve this they attempt to minimise the effect of restricting factors. These constraints include: varying income taxes and legislation (Arpan, 1992; Borkowski, 1992; Ernst and Young, 1997a; Plasschaert, 1979; Tang, 1992; Wu and Sharp, 1979; Yunker, 1982),

restrictions on profit and dividend repatriation (Arpan, 1992; Plasschaert, 1979; Tang, 1992; Yunker, 1982) and custom duties (Arpan, 1992; Plasschaert, 1979; Tang, 1992; Yunker, 1982). In addition and with the more stringent legislation and guidance of 1994 onwards, 'new' important considerations arose including documentation preparation for inspection and the effect of anti-trust legislation of foreign countries (Borkowski, 1997; Cravens and Shearon, 1997; Ernst and Young, 1997a; Tang 1992; Yunker, 1982).

MNEs should carry out analysis of any action they are considering in response to restrictions, in terms of the resultant effects on the ability to minimise other restrictions, the administrative burden and how this action might be perceived by authorities. The latter is particularly relevant to the largest, most 'public' MNEs (Al-Eryani et al, 1990; Benvignati, 1985; and Cravens and Shearon, 1997). Cravens and Shearon (1997) concluded that the latter size factor together with the legal variable have the only real significance on setting ITPs.

The increase in importance of ITP has warranted it a higher status in the decision-making framework of MNEs. Head Office-concentrated decision-making although conflicting with the popular adoption of decentralised management is describe by the Ernst and Young 1997 Transfer Pricing Report that recorded 78% of MNE respondents expecting to face examination of their transfer pricing policy in the following two years.

Chapter 2 explored ALP and showed four criticisms highlighted by Bucks and Mazerov (1993) and Mazerov (1994) that summed up the failure of ALP as a global solution to transfer pricing control: "The arm's length pricing system:

restrictions on profit and dividend repatriation (Arpan, 1992; Plasschaert, 1979; Tang, 1992; Yunker, 1982) and custom duties (Arpan, 1992; Plasschaert, 1979; Tang, 1992; Yunker, 1982). In addition and with the more stringent legislation and guidance of 1994 onwards, 'new' important considerations arose including documentation preparation for inspection and the effect of anti-trust legislation of foreign countries (Borkowski, 1997; Cravens and Shearon, 1997; Ernst and Young, 1997a; Tang 1992; Yunker, 1982).

MNEs should carry out analysis of any action they are considering in response to restrictions, in terms of the resultant effects on the ability to minimise other restrictions, the administrative burden and how this action might be perceived by authorities. The latter is particularly relevant to the largest, most 'public' MNEs (Al-Eryani et al, 1990; Benvignati, 1985; and Cravens and Shearon, 1997). Cravens and Shearon (1997) concluded that the latter size factor together with the legal variable have the only real significance on setting ITPs.

The increase in importance of ITP has warranted it a higher status in the decision-making framework of MNEs. Head Office-concentrated decision-making although conflicting with the popular adoption of decentralised management is describe by the Ernst and Young 1997 Transfer Pricing Report that recorded 78% of MNE respondents expecting to face examination of their transfer pricing policy in the following two years.

Chapter 2 explored ALP and showed four criticisms highlighted by Bucks and Mazerov (1993) and Mazerov (1994) that summed up the failure of ALP as a global solution to transfer pricing control: "The arm's length pricing system:

- costs the federal and state treasuries billions of dollars annually in unjustified and unnecessary revenue losses;
- diverts too many scarce resources to tax planning, complex accounting and auditing practices and lengthy litigation;
- creates inequities in tax payments and thereby tilts the competitive playing field by allowing global corporations to play transfer pricing games that entirely domestic firms are not even eligible to enter; and
- fails to guarantee any substantial degree of international uniformity in the division of income for tax purposes.

The 'fairness' behind the theory of ALP is good, but inherently the theory is inapplicable in all but the simplest transactions, rendering the three traditional transactional methods extraneous. ALP was introduced by the US and supported by the OECD when transactions and the structure of MNEs were much simpler. The growing complexities of MNEs, by their growth, size, and their nature equates to monopolistic characteristics. Regardless of these problems ALP is vastly acknowledged, which has taken time to achieve, and supposedly produces generally acceptable levels of income.

Because ALP is so well known, it would be too difficult, almost impossible, to replace it with something which would be as expansively recognised. It may be argued, however, that ALP is out of date, that although the principle is fair, the complexity of interrelated transactions renders TPMs relevant to a limited number of transactions. MNEs are expending huge resources attempting to show that the TPMs are relevant to all their transactions because they

do not want to face expensive investigation. It may also be argued, however, that ALP has evolved significantly in order to be relevant to the current global operations of MNEs, new methods and guidelines have been introduced, with the most specific changes relating to intangible property. This latter argument would appear to be the most popular, with countries continuing to use and adopt systems very similar to the US and OECD. One example investigated in this thesis was the UK (a well-developed, major trading nation) which has recently updated its regulations to echo the OECD application of ALP.

Adopting an alternative, although at present there is an absence of real options, would create whole new opportunities for double taxation and international dispute during the interim changing over period (which could take more than twenty years).

Chapter 2 looked at the problems introducing a new system based on global formulary apportionment (GFA) would bring and this would be the same for any alternative. GFA as the next 'best' alternative has not gained sufficient support to threaten the existence of ALP. Recommended by the US, particularly North Dakota and California where it has been adopted, GFA is argued to be a method using an accounting system most fitting to the reality of world trade conducted within a global enterprise. Audits would also be less time consuming. However, ALP is better equipped to cope with the changing exchange rates, differing accounting standards and use of multiple currencies (OECD, 1995). In addition, OECD (1995) argued that the cost savings of quicker audits are insignificant to the funds required to cover "intolerable compliance costs and data requirements" of GFA.

Chapter three explored the success of supplementary 'profit-based' methods in capturing the huge proportion of inter-related transactions that rendered inappropriate the use of the three traditional transaction methods. Some people have interpreted this use of profit-based comparisons as further indication of the failure of ALP.

Profit-based methods, by not depending on the comparability of inter-related and independent transactions, offer more flexibility than traditional TPMs. As opposed to TPMs, profit-based methods could find arm's length prices for intangible property.

The profit-split method is the most notable profit-based method, but its use is limited by the necessity for all relevant revenue authorities to agree on the underlying basis for allocating profits (Stitt, 1995).

The rapid growth of intangible property has caused huge problems, particularly as there are no exact comparables and no necessary links between the value of an intangible and the cost of maintaining it. Cost-sharing provisions, accepted by the OECD and US, provided for the expected benefits of an intangible to each party to be in proportion to the risk-sharing and cost contribution. The "commensurate with income" was founded on this idea and, although a 'fair' premise, problems have been experienced over documentation requirements to demonstrate profit distributions of intangible property in accordance to cost contributions.

CPM, as a TPM, demands the easiest and cheapest type of analysis is performed and although transfer prices are complicated to set they are the easiest to check. However, CPM is far from

receiving global approval, there is still debate over the arguable, non-arm's length characteristics of CPM. The harmonisation process has given some positive support to CPM as a last resort TPM.

There can be no doubt that there has been some collusion between the OECD and the US over ITP because of the resultant similarities between the guidelines and regulations. They continue to support ALP and deny the future of unitary approaches in ITP.

The core of harmonisation focused on the adoption of similar best method approaches. Under the latter, the over-riding preference (blatant in previous guidelines and regulations) for the use of traditional transaction methods were relaxed, instead taxpayers have 'freedom' to select and document use of any TPM, albeit the most appropriate one under the individual facts and circumstances.

The best method approach laid down the foundations for the introduction of TNMM in the OECD 1995 guidelines and the wider (although still minimal) acceptance of CPM. This is because the methods must be proved to be the most applicable TPM (in the US) and to adhere to the ALP (in the OECD) before tax authorities will accept them pricing inter-related transactions. The OECD accepted that the CPM could have some use in ITP, although it still has no plans to introduce CPM into future versions of the guidelines. Instead the OECD has provided a more acceptable orchestration of CPM in the form of the TNMM with some clear differences between the two.

The OECD and US provide similar standards of comparability in their regulations/guidelines and agree with the need for: functional analysis; acceptable arm's length ranges; and the use of multiple year data. They admit to difficulties in carrying out the above when transactions involve valuable intangible property. The US regulations allow for periodic adjustments to royalty rates whilst the OECD is openly cautious about this approach.

The US regulations and OECD guidelines have not relieved the expansive documentation requirements. There is a greater burden on US-based MNEs and penalties maintain control over taxpayers in the US to ensure their compliance with the requisite information. The use of penalties to control taxpayers and maximise their tax revenue stream has appealed to numerous jurisdictions (including Japan and the UK) despite the prudent approach recommended by the OECD.

The real result of harmonisation is, according to Greenhill and Bee (1996), that "US taxpayers who comply with Section 482 regulations should not be exposed to a significant risk of double taxation in OECD member countries" and vice versa.

The future should, therefore, be about trying to make the ALP (in the guidelines and regulations together) more relevant and up to date with global trading. In addition, taxpayers need more help deciding and documenting the most appropriate TPMs, for example with the provision of more case studies on the five approved methods. In addition to the latter, the OECD (1997) are concerned with the following two areas:

application of the general principles of the guidelines in complex situations; and
improvement of the implementation of the guidelines and the design of administrative

procedures.

The US should also be concerned with the above problems with reference to their own regulations.

The OECD guidelines and the US regulations have brought enormous world-wide attention to ITP. Particularly in the last fifteen years, countries have learnt about the potential tax manipulation ITP practices of MNEs, seen the potential increase in tax revenue from placing some controls, and introduced a system based on the ALP. Chapter 6 shows a 'knock-on' effect in the history of ITP policing. The US introduced ALP in an effort to minimise lost tax revenues from tax manipulation. The US then aimed to educate the world about the use of ALP and the OECD, being one of the first to recognise ALP, introduced ITP guidelines. Over the past fifteen years in particular, a majority of countries have learnt from the changing ITP regulations and guidelines and have issued measures themselves. These have mostly mirrored the OECD 1995 guidelines. Chapter 7 showed that the UK was a typical example.

The introduction of APAs offered companies the opportunity to approach tax administrations and present their business with what they perceived to be the most applicable (or least inapplicable) TPM for open discussion in advance of actually setting them. This "open forum" approach is certainly something that could aid support in the future for the ALP, although some critics have noted that the introduction of APAs is a statement of the failure of ALP.

APAs offer chances for MNEs to show the profits of businesses carrying out similar transactions and present cases why they differ in make-up and would differ in their policies. Instead of being defensive about their TPMs they can present them positively.

APAs 'could' be a positive step in the transfer pricing debate; however, the number of drawbacks that exist currently prevents a very large demand for them. They are too prescriptive and structured, particularly when thinking of the US system (Canada, for example, offers a much more relaxed approach). APAs generally ask for too much from a taxpayer, for too much detail, too much time and too much sensitive data to be revealed.

The first case, Apple Computer, is an example of a company that suffered repeated transfer pricing enquiries and adjustments and had no other option but APAs. Certainly, they are increasing in popularity, but perhaps more as a result (as with Apple Computer) of the failure of companies to support their TPMs convincingly enough not to face continued and repetitive attention combined with transfer pricing adjustments.

Hopefully over time APA processes will be refined and companies will approach them not as a last resort but as the most beneficial and most appropriate ITP option available to them. A relaxation in the regulations would encourage a greater all round appreciation of pre-TPM setting negotiations and a willingness to settle transfer pricing problems in a less hostile environment.

With the lack of alternatives to ALP, APAs, with an adequate number of trained tax officials, are the only way to stop the level of legislation world-wide spiralling out of control in the competition among governments to claim the most tax dollars.

In addition, the huge network of double tax treaties would keep governments aware of each other's position on MNE taxation and allow information exchange to increase their knowledge of the MNEs global operations. In the past governments have only been able to guess at an MNE's global operations from the data they received on the trade involving their country. This has resulted in an atmosphere of distrust of the objectives of MNEs. A government's appreciation of the tax demands of other governments on an MNE and an MNEs understanding that a government is educated in the MNE's global trading would create a more informed environment in which to communicate.

The future of ITP is uncertain. On the one hand legislation could become ever more prescriptive, restrictive on taxpayers and increasingly penalty-policed. With the growth of treaty networks and the global exchange of information on MNEs amongst governments, combined with most countries being aware of ITP and adopting systems mirroring the OECD and US, including increasing 'open-forum' APAs, there does not appear to be a need for more restrictive regulations. This would only lead to further bad feeling on the part of MNEs towards governments and further inhibit world trade (since ITP regulation is already a significant cost of world-trade).

An alternative and more realistic future is that the treaty networks and inter-governmental communication networks could develop such that jurisdictions could decide together the proportion of an MNE's global profit taxable in each jurisdiction. This option, however, is the most government-biased one i.e. the authorities could decide, regardless of an MNE's contribution, where different proportions of the profits would be taxed. The benefit to MNE's with this is that the resource expenditure would be absorbed mostly by the tax administrations.

The final option is that ALP as a whole could be replaced and this is unlikely in the present absence of realistic alternatives. As ALP becomes more widely acknowledged as an inapplicable solution to ITP, especially with future advances in global trading, and with knowledge of an alternative course then the future of ALP will obviously need to be re-examined.

The realistic future, and indeed the direction of international transfer pricing appears to be going in, is a combination of a relaxing in the rules for obtaining APAs and a maximisation in the use of the treaty networks. These options offer the most success of making ALP usable for the longest period of time, perhaps because the emphasis is away from the actual TPM and towards open discussion and information exchange on the operations of MNEs.

APPENDICES

APPENDIX 1

ESTIMATES OF THE VALUE OF TRANSFER PRICING TRANSACTIONS.

"The Ruding Committee (1992) estimated the value of transfer pricing transactions involving EC countries based on 1989 data. Although sizeable amounts, these estimates do not include payments for services, interest, royalties, licences, and know-how fees."

	billions ECUs
Transfer prices within the EC	307
Transfer prices EC : North/South America	108
Transfer prices EC : Asia/Pacific	90
Transfer prices EC : Rest of world	226
TOTAL	731

Source: Elliott, J. 1995. *Transfer Pricing. Intelligent Systems in Accounting and Finance.*

APPENDIX 2

DIFFERENCE IN IMPORTANCE OF VARIABLES IN TRANSFER PRICING
DETERMINATION

	PARENT NATIONALITY						
	USA	Canada	France	W Germany	Italy	Scandinavia	UK
Income Tax	1	1	1	3	1	3	3
Customs Duties	2	2	2	3	3	3	3
Inflation	1	2	2	2	2	3	2
Changes in currency rates	3	3	2	2	3	3	2
Exchange controls	2	3	5	5	5	5	5
Improving financial appearance of subsidiary	3	3	3	4	4	4	1
Expropriation	3	3	5	5	5	5	5
Export subsidiaries and tax credits	4	2	2	4	2	4	2
Level of competition	4	2	2	3	2	3	3

Weighting Scale: 1 = High importance

 2 = Medium importance

 3 = Low importance

 4 = Not mentioned

 5 = Mentioned only with respect to non-US operations

Source: *Arpan, J.S. 1988. International Intercompany Pricing*
in Issues in Multinational Accounting eds. Nobes, C. and Parker, R.

APPENDIX 3

PROFIT SPLIT METHOD DEFINITION FROM 1993 US TEMPORARY REGULATIONS

Three methods

1. *"Residual allocation"* profit split method.

It has a two step approach:

Identify parties' routine functions and assigning a market return to those functions

Dividing residual profit on the basis of relative value of each party's contribution of intangible property.

2. *"Capital employed allocation"* profit split method.

Allocates combined profit or loss based on the ratio of the relative capital employed by the controlled taxpayers.

3. *"Comparable"* profit split method.

Based on the relative profits of uncontrolled taxpayers engaged in transactions and functions similar to those of the controlled taxpayer.

Source: *Ogum, G. and Kim, K.A. 1995. New US International Transfer Pricing Regulations. Multinational Business Review. Spring.*

APPENDIX 4

CPM DEFINITION TAKEN FROM 1993 US TEMPORARY REGULATIONS

Taxpayers should apply several steps when using the CPM:

First: Determine the "tested" party

This party is ordinarily the controlled taxpayer that performs the simplest and, therefore, most easily compared operations.

Second: Determine the appropriate "business segment"

To evaluate the tested party. Generally the CPM is applied separately to each industry.

Third: Select comparable companies for benchmarking purposes

The greater the similarity of the comparable, the more reliable it is as the measure of the arm's length price.

Fourth: Make adjustments

To improve consistency and to achieve greater similarity between comparable parties and the tested party.

Fifth: Must determine appropriate profit-level indicators

For example, financial ratios, such as return on capital or return on operating assets, that measure the relationships between profits, costs incurred, and resources employed.

Sixth: Apply the single best price-level indicator

Apply against the company results to simulate a range of "constructed operating income" results.

In other words, if taxpayers take these steps and make all the necessary adjustments, their arm's length range would include all constructed operating profits derived from the comparables.

Source: *Ogum, G. and Kim, K.A. 1995. New US International Transfer Pricing Regulations. Multinational Business Review. Spring.*

APPENDIX 5

UK 1970 TAXES MANAGEMENT ACT - SECTION 30C

Determinants Requiring the Sanction of the Board

1. This section has effect where a determination requiring the Board's sanction is made for any of the following purposes, that is to say -
 - a) the giving of a notice under section 28A(5) or 28B(5) of this Act stating the conclusions of an officer of the Board in relation to any self assessment or partnership statement;
 - b) the making of an assessment under section 29 of this Act; or
 - c) the giving of a notice under section 30B(1) of this Act amending a partnership statement.
2. If the notice under section 28A(5), 28B(5) or 30B(1) of this Act or, as the case may be, the notice of the assessment under section 29 of this Act is given to any person without -
 - a) the determination, so far as it is taken into account in the notice, having been approved by the Board, or
 - b) a copy of the Board's approval having been served on that person at or before the time of the giving of the notice, the notice under section 28A(5), 28B(5) or 30B(1) or, as the case may be, the assessment under section 29 shall be deemed to have been given or made (and in the case of an assessment notified) in the terms (if any) in which it would have been given or made had that determination not been taken into account.

3. For the purposes of this section the Board's approval of a determination requiring their sanction -
 - a) must be given specifically in relation to the case in question and must apply to the amount determined; but
 - b) subject to that, may be given by the Board (either before or after the making of the determination) in any such form or manner as they may determine.
4. In this section references to a determination requiring the Board's sanction are references (subject to subsection 5 below) to any determination of an amount falling to be brought into account for tax purposes in respect of any assumption made by virtue of paragraph 1(2) of Schedule 28AA to the principal Act (provision not at arm's length).
5. For the purposes of this section a determination shall be taken, in relation to a notice under section 28A(5), 28B(5) or 30B(1) of this Act or an assessment under section 29 of this Act, not to be a determination requiring the Board's sanction if -
 - a) an agreement about the matters to which the determination relates has been made between an officer of the Board and the person in whose case it is made;
 - b) that agreement is in force at the time of the giving of the notice or, as the case may be, of any notice of the assessment; and
 - c) the matters to which the agreement relates include the amount determined.
6. For the purposes of subsection 5 above an agreement made between an officer of the Board and any person ("the taxpayer") in relation to any matter shall be taken to be in

force at any time if, and only if -

- a) the agreement is one which has been made or confirmed in writing;

that time is after the end of the period of thirty days beginning -

- i) in the case of an agreement made in writing, with the day of the making of the agreement, and
- ii) in any other case, with the day of the agreement's confirmation in writing.

Source: *Inland Revenue. 1997. Modernisation of the Transfer Pricing Legislation. Consultative document.*

APPENDIX 6

UK TRANSFER PRICING DOCUMENTATION REQUIREMENT

Consultative Document

Appendix II: Documentation Requirement

This guidance note explains the Inland Revenue's approach to construing this record-keeping requirement for the purposes of the transfer pricing legislation. It sets out the sorts of documents which the Inland Revenue expects taxpayers to prepare and retain for tax purposes. It also gives details of those records which should be retained if (but only if) taxpayers prepare them for their own commercial reasons. And it gives an indication of the records which taxpayers are not expected to prepare or retain.

Documents which taxpayers are expected to prepare and retain

The Inland Revenue expects documentation in relation to a taxpayer's transfer pricing arrangements to be created or referred to and retained in accordance with the same prudent business management principles which would govern the process of evaluating a business decision of a similar level of complexity and importance. These records should show a taxpayer's efforts to comply with the arm's length principle and should include the information

on which any transfer prices were based, a record of the factors taken into account and details of the method selected.

For each period, such records will normally be expected to include:

- a record of the taxpayer's relevant transactions and the extent of any other commercial or financial relations with associated enterprises within the scope of the legislation;
- a record of the nature and terms of any transactions with associated enterprises within the scope of the legislation, and where the terms of any transaction change during the period, a record of the re-negotiation of those terms and the circumstances giving rise to the change;
- all commercial agreements entered into by the taxpayer, whether with associated enterprises within the scope of the legislation or with independent third parties, including:
 - distribution agreements
 - manufacture or supply agreements
 - service contracts
 - agreements relating to research and development
 - loan or other financial agreements
 - licence agreements
 - cost-sharing agreements,

and any other documents relating to the negotiation of the terms of these agreements;

- all investment appraisals undertaken by the taxpayer in relation to an investment in or involving associated enterprises within the scope of the legislation;

- in relation to transactions or series of transactions involving associated enterprises considered in evaluating its transfer pricing arrangements under the arm's length principle, including a record of the factors taken into account and of the decision-making process;
- in relation to transactions or series of transactions involving associated enterprises within the scope of the legislation, a record of the transfer pricing method selected and why it was considered it would produce arm's length pricing; where the application of the transfer pricing method selected relies on comparability data (prices, margins etc.) any such data used by the taxpayer in the application of the method should also be retained;
- a record of any price negotiations with associated enterprises within the scope of the legislation;
- a record of any offsetting transactions taken into account in determining the pricing for any transactions or series of transactions involving associated enterprises within the scope of the legislation;
- a record of the nature, terms and pricing relating to any uncontrolled transactions or series of transactions in which the taxpayer was involved, and which are relevant for determining the arm's length price for any comparable transactions or series of transactions involving the taxpayer and an associated enterprise within the scope of the legislation;
- a record of any business or management or pricing strategy adopted by the taxpayer and the reasons for adopting it;
- a record of any budgets or forecasts prepared; where budgets or forecasts are prepared by reference not only to the taxpayer's business as a whole, but also to each separate business, trade or division and/or to each product or product line, these should also be retained by the taxpayer;

- a record of any financial including profit and loss information prepared; where financial information was prepared by reference not only to a taxpayer's business as a whole but also to each separate business, trade or division and/or to each product or product line, this should also be retained by the taxpayer.

The Inland Revenue considers that most of the records listed above would be prepared by most taxpayers in accordance with the principles of prudent business management without reference to tax considerations. It may, however, be necessary for taxpayers to prepare or refer to documents of the kind listed above which would not have been prepared or referred to in the absence of tax considerations. Taxpayers are only expected to prepare or retain such records if they are indispensable for a reasonable assessment of whether the taxpayer's transfer pricing arrangements reflected in its tax returns satisfy the arm's length principle and can be prepared or retained by the taxpayer without a disproportionately high cost being incurred.

Many of the records listed above will be prepared by a taxpayer every year. In some cases, however, taxpayers may not judge it necessary to prepare a new record every year - for example in relation to the transfer pricing method selected and the reasons for selecting it.

Where there has been no material change in the relevant circumstances, the Inland Revenue accepts that records prepared in a previous accounting period, which are relevant to the transfer pricing arrangements adopted in the accounting period under review, may satisfy the record keeping requirement.

Documents which taxpayers should retain if they prepare or obtain them

Some taxpayers undertake considerable in-depth analysis in developing and implementing an overall group-wide transfer pricing policy, perhaps for other commercial reasons. Where such analysis is undertaken, any documents, reports or other records produced or obtained should be retained by the taxpayer.

Such records might include the following:

- a formal written statement of the taxpayer's transfer pricing policy;
- a pricing appraisal or other report giving consideration to the basis on which a taxpayer's transfer prices should be set and the factors to be taken into account;
- a comparability analysis, whether by reference to individual transactions or series of transactions;
- a functional analysis.

The Inland Revenue does not expect a taxpayer routinely to prepare such documents, reports or other records solely for UK tax purposes. However, it may be necessary for taxpayers to undertake some analysis of this kind during the course of any transfer pricing enquiry.

Documents which taxpayers are not expected to prepare or retain

The Inland Revenue will not expect taxpayers to:

- determine which, of a number of appropriate options, is the 'best' transfer pricing method;
- consider comparable data (prices, margins, etc.) from any uncontrolled transactions or series of transactions to which the taxpayer or an associated enterprise was not a party, unless such data is available to them.

The Inland Revenue will not expect taxpayers to prepare any documents in relation to such considerations.

Source: ***Inland Revenue. 1997. Modernisation of the Transfer Pricing Legislation. Consultative document.***

APPENDIX 7

QUESTIONS ON THE UK USE OF ADVANCE PRICING AGREEMENTS

Chapter 6: Administrative Issues

Section I: Advance Pricing Agreements

6.41 General comments arising from this brief overview of APAs would be welcome. In addition the Government invites taxpayers' views relating to the following questions:

- Is there support for the proposition that the Inland Revenue should make the APA process available to taxpayers? Is that support affected by the proposed legislative changes discussed in this document?
- Is that support qualified by perceived disadvantages in the APA procedure as it is currently understood? What are those disadvantages and how might they be removed?
- Does the Mutual Agreement Procedure afford a satisfactory means by which UK taxpayers may obtain an APA, or would formal domestic legislative provisions be preferable? If preferable, is this essentially in order to establish domestic legal authority or in order to alter the procedure?

- Is there perceived to be a lack of understanding about the procedures by which APAs may be obtained, and would the issue of guidance notes be helpful?
- Is there an interest in applying for APAs on a unilateral basis, that is an understanding with the UK tax administration alone, bearing in mind both that any such arrangements may not eliminate double taxation and that they are informal and non-binding?

Source: *Inland Revenue. 1997. Modernisation of the Transfer Pricing Legislation. Consultative document.*

APPENDIX 8

ARTICLE 9 OF OECD MODEL TAX TREATY

1. Where

- a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
- b) the same person participates directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

2. Where a Contracting State includes in the profits of an enterprise of that State - and taxes accordingly - profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other

State shall make an appropriate adjustment to the amount of tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.

Source: *Inland Revenue. 1997. Modernisation of the Transfer Pricing Legislation. Consultative document.*

GLOSSARY

GLOSSARY

The following glossary is extracted from the 1995 OECD Guidelines for reference.

Advance Pricing Agreement (APA)

An arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time. An advance pricing arrangement may be unilateral involving one tax administration and a taxpayer or multilateral involving the agreement of two or more tax administrations.

Arm's Length Principle

The international standard that OECD Member countries have agreed should be used for determining transfer prices for tax purposes. It is set forth in Article 9 of the OECD Model Tax Convention as follows: where "conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those

conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly".

Arm's Length Range

A range of figures that are acceptable for establishing whether the conditions of a controlled transaction are arm's length and that are derived either from applying the same transfer pricing method to multiple comparable data or from applying different transfer pricing methods.

Associated Enterprises

Two enterprises are associated enterprises with respect to each other if one of the enterprises meets the conditions of Article 9, sub-paragraphs 1a) or 1b) of the OECD Model Tax Convention with respect to the other enterprise.

Comparability Analysis

A comparison of a controlled transaction with an uncontrolled transaction or transactions.

Controlled and uncontrolled transactions are comparable if none of the differences between the transactions could materially affect the factor being examined in the methodology (e.g.

price or margin), or if reasonably accurate adjustments can be made to eliminate the material effects of any such differences.

Comparable Uncontrolled Price (CUP)

A transfer pricing method that compares the price for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances.

Compensating Adjustment

An adjustment in which the taxpayer reports a transfer price for tax purposes that is, in the taxpayer's opinion, an arm's length price for a controlled transaction, even though this price differs from the amount actually charged between the associated enterprises. This adjustment would be made before the tax return is filed.

Contribution Analysis

An analysis used in the profit split method under which the combined profits from controlled transactions are divided between the associated enterprises based upon the relative value of

the functions performed (taking into account assets used and risks assumed) by each of the associated enterprises participating in those transactions, supplemented as much as possible by external market data that indicate how independent enterprises would have divided profits in similar circumstances.

Controlled Transactions

Transactions between two enterprises that are associated enterprises with respect to each other.

Corresponding Adjustment

An adjustment to the tax liability of the associated enterprise in a second tax jurisdiction made by the tax administration of that jurisdiction, corresponding to a primary adjustment made by the tax administration in a first tax jurisdiction, so that the allocation of profits by the two jurisdictions is consistent.

Cost Plus Mark Up

A mark up that is measured by reference to margins computed after the direct and indirect costs incurred by a supplier of property or services in a transaction.

Cost Plus Method

A transfer pricing method using the costs incurred by the supplier of property (or services) in a controlled transaction. An appropriate cost plus mark up is added to this cost, to make an appropriate profit in light of the functions performed (taking into account assets used and risks assumed) and the market conditions. What is arrived at after adding the cost plus mark up to the above costs may be regarded as an arm's length price of the original controlled transaction.

Direct Costs

Costs that are incurred specifically for producing a product or rendering service, such as the cost of raw materials.

Functional Analysis

An analysis of the functions performed (taking into account assets used and risks assumed) by associated enterprises in controlled transactions and by independent enterprises in comparable uncontrolled transactions.

Global Formulary Apportionment

A method to allocate the global profits of an MNE group on a consolidated basis among the associated enterprises in different countries on the basis of a predetermined formula.

Gross Profits

The gross profits from a business transaction are the amount computed by deducting from the gross receipts of the transaction the allocable purchases or production costs of sales, with due adjustment for increases or decreases in inventory or stock-in-trade, but without taking account of other expenses.

Independent Enterprises

Two enterprises are independent enterprises with respect to each other if they are not associated enterprises with respect to each other.

Indirect Costs

Costs of producing a product or service, which, although closely related to the production process, may be common to several products or services (for example, the costs of a repair department that services equipment used to produce different products).

Multinational Enterprise Group (MNE group)

A group of associated companies with business establishments in two or more countries.

Multinational Enterprise

A company that is part of an MNE group.

Mutual Agreement Procedure

A means through which tax administrations consult to resolve disputed regarding the application of double tax conventions. This procedure, described and authorised by Article 25 of the OECD Model Tax Convention, can be used to eliminate double taxation that could arise from a transfer pricing adjustment.

Profit Split Method

A transactional profit split method that identifies the combined profit to be split for the associated enterprises from a controlled transaction (or controlled transactions that it is appropriate to aggregate under the principles of Chapter I) and then splits those profits between the associated enterprises based upon an economically valid basis that approximated the division of profits that would have been anticipated and reflected in an agreement made at arm's length.

Resale Price Margin

A margin representing the amount out of which a reseller would seek to cover its selling and other operating expenses and, in light of the functions performed (taking into account assets used and risks assumed), make an appropriate profit.

Resale Price Method

A transfer pricing method based on the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise. The resale price is reduced by the resale price margin. What is left after subtracting the resale price margin can be regarded, after adjustment for other costs associated with the purchase of the product (e.g. custom duties), as an arm's length price of the original transfer of property between the associated enterprises.

Residual Analysis

An analysis used in the profit split method divides the combined profit from the controlled transactions under examination in two stages. In the first stage, each participant is allocated sufficient profit to provide it with a basic return appropriate for the type of transactions in which it is engaged. Ordinarily this basic return would generally not account for the return that would be generated by any unique and valuable assets possessed by the participants. In the second stage, any residual profit (or loss) remaining after the first stage division would be allocated among the parties based on an analysis of the facts and circumstances that might indicate how this residual would have been divided between independent enterprises.

Secondary Adjustment

An adjustment that arises from imposing tax on a secondary transaction.

Secondary Transaction

A constructive transaction that some countries will assert under their domestic legislation after having proposed a primary adjustment in order to make the actual allocation of profits consistent with the primary adjustment. Secondary transactions may take the form of constructive dividends, constructive equity contributions, or constructive loans.

Simultaneous Tax Examinations

A simultaneous tax examination, as defined in Part A of the OECD Model Agreement for the Undertaking of Simultaneous Tax Examinations, means an "arrangement between two or more parties to examine simultaneously and independently, each on its own territory, the tax affairs of (a) taxpayer(s) in which they have a common or related interest with a view to exchanging any relevant information which they so obtain".

Traditional Transaction Methods

The comparable uncontrolled price method, the resale price method, and the cost plus method.

Transactional Net Margin Method

A transactional profit method that examines the net profit margin relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realises from a controlled transaction (or transaction that it is appropriate to aggregate under the principles of Chapter I).

Transactional Profit Method

A transfer pricing method that examines the profits that arise from particular controlled transactions of one or more of the associated enterprises participating in those transactions.

Uncontrolled Transactions

Transactions between enterprises that are independent enterprises with respect to each other.

BIBLIOGRAPHY

BIBLIOGRAPHY

- Abdallah, W.M. 1989. *International Transfer Pricing Policies: Decision Making Guidelines for Multinational Companies*. Quorum Books, Connecticut.
- Adams, C. 1997. Transfer Pricing: Confusion Over Tax Treatment. *Financial Times*. 2 September. pp4.
- Al-Eryani, M.P., Alam, P. and Akhter, S.H. 1990. Transfer Pricing Determinants of U.S. Multinationals. *Journal of International Business Studies*, Third Quarter. pp 409-425.
- Anonymous. 1994a. The Advance Pricing Agreement Program (APA). *Management Accounting*. December. pp47.
- Anonymous. 1994b. Transfer Pricing Report Will Have Major Impact. *Management Accounting*. September. pp6.
- Anonymous. 1995a . Transfer Pricing/Arbitration. *Accountancy*. March. pp118.
- Anonymous. 1995b. On the Tax Borderline. *Management Today*. November pp17-18.
- Arnold, B.J and McIntyre, M.J. 1994. Transfer Pricing. *International Tax Primer*. Kluwer Law International. pp53-68.
- Arpan, J.S. 1972. International Intercompany Pricing: Non-American Systems and Views. *Journal of International Business Studies*.
- Arpan, J.S. 1988. International Transfer Pricing in Issues in Multinational Accounting eds. C. Nobes and R. Parker. Philip Allan Publishers.
- Atkinson, M and Tyrrall, D. 1997. International Transfer Pricing: The Tax Man Commeth. *Journal of Applied Accounting Research*. December.

- Barratt, R.W. 1995. Confronting Tax Havens, The Offshore Phenomenon, and Money Laundering. *International Tax Journal*. pp12-37.
- Bennett, P. 1996. Transfer Pricing. *Tax Monitor*. February. KPMG Ireland.
- Benson, D.M. 1996. Entering Foreign Markets - One Step at a Time. *The Tax Adviser*. October. pp628-631.
- Benson, I. and Lloyd, J. 1983. *New Technology and Industrial Change*. Kogan Page Limited, London.
- Benvignati, A.M. 1985. An Empirical Investigation of International Transfer Pricing by US Manufacturing Firms. In *Multinationals and Transfer Pricing*, edited by A.M.Rugman and L.Eden. New York: St Martin's Press.
- Benvignati, A.M. 1987. Domestic Profit Advantages of Multinational Firms. *Journal of Business*. Vol. 60, no. 3.
- Boatman, K. 1997. OECD Transfer Pricing Update: Challenge for Taxpayers and Tax Authorities. *International Tax Journal*. Summer. Vol 23, no. 3. pp1-5.
- Bonturi, M. and Fukasaku, K. 1993. Globalisation and Intra-Firm Trade: An Empirical Note. *OECD Economic Studies*. Spring. No. 20. pp145-159.
- Borkowski, S.C. 1992. Organizational and International Factors Affecting Multinational Transfer Pricing. *Advances in International Accounting*. Vol. 5. pp173-192.
- Borkowski, S.C. 1996. An Analysis (Meta- and Otherwise) of Multinational Transfer Pricing Research. *The International Journal of Accounting*. Vol. 21, No. 1. pp39-53.
- Borkowski, S.C. 1997. Factors Motivating Transfer Pricing Choices of Japanese and United States Transnational Corporations. *International Accounting, Auditing and Taxations*, 6(1). pp25-47.

- Borstell, T., Huibregtse, S.B., Miyamoto, A and Sporken, C.J.E.A. (Price Waterhouse's worldwide transfer pricing group). 1997a. OECD: Global Theory, Local Practice. *International Tax Review*. May. www.lawmoney.oyster.co.uk/publications/ITR97/itr9705/itr9507.4.html (accessed at: 6 March 1998).
- Borstell, T., Huibregtse, S.B., Miyamoto, A and Sporken, C.J.E.A. (Price Waterhouse's worldwide transfer pricing group). 1997b. OECD: Global Theory, Local Practice (Part Two). *International Tax Review*. June.
- Bowman, C. 1997. Poland: Transfer Pricing. *Global Tax Communique*. Coopers and Lybrand. August.
- Buckley, P.J. and Frecknall Hughes, J. 1997. Transfer Pricing and Economic Functions Analysis: The Japanese Paradigm. *Applied Economics*. Issue 4. pp13-17.
- Bucks, D.R. and Mazerov, M. 1993. The State Solution to the Federal Governments International TP Problem. *National Tax Journal*. September. Vol 81, issue 3.
- Calleja, A. 1997. Spanish APAs: Advanced Pricing Agreements or Approvals? *International Tax Review*, International Update. September. www.lawmoney.com/public/co...ions/ITR9709/itr9709.7.html. (accessed at: 6 February).
- Cannon, P. 1997. Investigations: Wise Up or Pay the Price. *International Tax Review*. June.
- Chip, W. and Coronado, L. 1997. Mexico: Transfer Pricing Studies Due By March 31. *International Tax Review*. December. www.lawmoney.com/public/co...ons/ITR97/itr9712/itr9712.8ihtml (accessed at: 2 June 1998).
- Choi, F.D.S. and Mueller, G.G. 1984. *International Accounting*. 2nd edition, Prentice-Hall International, New Jersey.
- Clark, R. and Dodge, W. 1997. Hybrid Methods - Bridging the Gap. *Transfer Pricing 1997*. Deloitte and Touche LLP. pp129-135.

- Coopers and Lybrand. 1995(a). Canada Embraces Advance Pricing Agreements. *Global Tax Communique, CPA Journal*. October.
- Coopers and Lybrand. 1995(b). Final Transfer Pricing Penalty Regulations Reflect Few Changes. *Global Tax Communique*. October. www.colybrand.com/tax/tnn/gtc10-95.html (accessed: at 27 February 1998).
- Coopers and Lybrand. 1997(a). *Modernisation of the Transfer Pricing Legislation - proposed legislation and consultative document: Representations prepared by Coopers and Lybrand*.
- Coopers and Lybrand. 1997(b). United Kingdom: Transfer Pricing. *Global Tax Communique*. Winter. pp19.
- Coppinger, W.T. 1995. Steps to Take in Preparing and Dealing with an IRS Examination. *CPA Journal*. March.
- Cravens, K.S. and Shearon, W.T. 1996. An Outcome-Based Assessment of International TP Policy. *The International Journal of Accounting*. Vol. 31, no.4. pp419-443.
- Curet, O and Elliott, J. 1997. Understanding Transfer Pricing - A Case-Based Reasoning Approach. *European Journal of Information Systems*. Vol. 6, issue 2. pp97-106.
- Daniels, J.D. and Radebaugh, L.H. 1992. *International Business Environments and Operations*. Sixth Edition. Addison-Wesley Publishing Company.
- Deloitte and Touche. 1997. *Representations on Inland Revenue Consultative Document: Modernisation of the Transfer Pricing Legislation*.
- Deloitte Touche Tohmatsu International. 1997. UK Inland Revenue Announces Comprehensive Review of Transfer Pricing Law and Practice. *Global Transfer Pricing Developments*. The Arm's Length Standard. Special Edition. October.

- Deloitte Touche Tohmatsu International. 1998a. UK Inland Revenue Responds to our Representations. *Global Transfer Pricing Developments*. The New UK Transfer Pricing Regulations. Special Edition. March.
- Deloitte Touche Tohmatsu International. 1998b. *Managing the Competent Authority Process*.
- Deloitte Touche Tohmatsu International. 1998c. *Transfer Pricing Software*.
- Dennis, A. 1997. Mapping Out a Tax Plan. *Journal of Accountancy*. September. pp45-47.
- Drury, C. 1995. *Management and Cost Accounting*. Third Edition. Chapman and Hall..
- Durst, M. and Fiamma, S. 1993. US Steps Up Enforcement of Transfer Pricing Rules. *Corporate Finance*. May. pp43-45.
- Dykes, I. 1998. Interview: Tax Manager at Deloitte and Touche, Birmingham.
- European Community. 1990. EC Convention - on the Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises. 90/436EEC. July.
- Eccles, R.G. 1986. *The Transfer Pricing Problem: A Theory for Practice*. Heath, Lexington Books, Massachusetts/Toronto.
- Elliott, J. 1995a. Developments in Transfer Pricing. *British Tax Review*. No. 4, pp348-357.
- Elliott, J. 1995b. Transfer Pricing. *Intelligent Systems in Accounting and Finance*.. pp4661.
- Elliott, J. 1996. Developments in the Tax Treatment of Foreign-owned Companies. *Journal of Applied Accounting Research*. October. pp73-89.
- Elliott, J. 1997. Transfer Pricing: Lessons from Australia. *Discussion Papers in the Department of Management*. University of Southampton. October. No.97-135.

Elliott, J. 1998. *International Transfer Pricing Policy: A Grounded Theory Approach*.
Presented at the British Accounting Association Annual Conference. April.

Epstein, B. 1990. Potential Opportunities and Costs in Filing for an Advanced Determination Ruling on International Transfer Prices. *Tax Management International Journal*. Articles. pp480-483.

Ernst and Young. 1995. Transfer Pricing - Are We Going the American Way Asks Ernst and Young.

Ernst and Young. 1996. Transfer Pricing Guidelines Encourage Tax Authorities to Take Tougher Line Warn Ernst and Young. May.

Ernst and Young. 1997(a). *Transfer Pricing Report*.. Ernst and Young International Ltd.

Ernst and Young. 1997(b). *Multinationals face UK transfer pricing deadline*. Lawmoney. December.

Ernst and Young. 1998(a). *Consultative Document - Reform of the Transfer Pricing Legislation*.

Ernst and Young. 1998(b). *Consultative Document - Reform of the Transfer Pricing Legislation: APAs*.

Farrell, E.L. 1991. Penalty on Assessments Due to Sec. 482 Pricing Adjustments. *The Tax Adviser*. February. pp93-95.

Federal Trust for Education and Research and Ernst and Young. 1991. *The Future of Corporate Tax in the European Community*. Kogan Page Ltd, London.

Feinschreiber, R. 1992. Advance Pricing Agreements: Advantageous or Not? *CPA Journal*. June.

- Forster, D. 1997. Canada: Transfer Pricing. *Global Tax Communique*. Coopers and Lybrand. Spring.
- Freshfields International Tax Group. 1997. UK Budget: UK Adds to Corporate Workload. *International Tax Review*. February.
- Ghosh, D. and Crain, T.L. 1993. A Transfer Pricing Decision Model for Multinationals. *The International Journal of Accounting* 28:pp170-181.
- Gordon, R.A., Venuti, J. and Galan, A.E. 1991. An Analysis of Tax Information Exchange Agreements Concluded by the US. *Tax Management International Journal*. February. pp187-197.
- Gould, G. 1997. Advance Pricing Agreement May Solve Transfer Pricing Problems. *GT Online - Tax and Benefits*. In Tax and Business Adviser (Grant Thornton newsletter). Vol. 10, no.4. July/August
- Greenhill, M. and Bee, C.W. 1996. Transfer Pricing Guidelines Issued by the OECD. *The Tax Adviser*. May. pp265-267.
- Groenen, A. and Spierendonk, S. 1994. Flexible Approach to the Dutch Regime. *International Tax Review*. Supplement. pp21-26.
- Halperin, R and Srinidhi, B. 1996. U.S. Income Tax Transfer Pricing Rules For Intangibles as Approximations of Arm's Length Pricing. *The Accounting Review*. Vol. 71, no.1. January. pp61-80.
- Hembrey, D. 1995a. U.S. Spars With France And Germany Over Controversial TP Guidelines. *Newsletter: Wash.Int.Report*. Arent Fox Kintner Plotkin and Kahn. February.
- Hembrey, D. 1995b. OECD Issues New Tp Guidelines Amid U.S.-European Conflict. *Newsletter: Wash.Int.Report*. Arent Fox Kintner Plotkin and Kahn. February.

- Hickman, A. 1998. Interview: International Specialist and Competent Authority Specialist, International Division, Inland Revenue.
- Hoshower, L.B. and Mandel, L.A. Transfer Pricing Policies of Diversified US-Based Multinationals. *The International Journal of Accounting*.
- Hufbauer, G.C. 1992. *U.S Taxation of International Income*. Institute for International Economics. pp107-122.
- Humphreys, B. 1994. International Transfer Pricing: More Important Than Ever Before. *CMA Magazine*. vol. 68, issue. 4. pp24-26.
- Inland Revenue. 1978a. *Double Taxation: United Kingdom and United States of America*. Press Release: February.
- Inland Revenue. 1978b. *Double Taxation: Exchange of Information with the United States of America*. Press Release: March.
- Inland Revenue. 1981. *Transfer Pricing of Multinational Enterprises: Notes for Guidance*. Press Release: January.
- Inland Revenue. 1997a. *Double Taxation Conventions*. Press Release: 102/97. October.
- Inland Revenue. 1997b. *Double Taxation Agreements: Falkland Islands, Lesotho, Malaysia and Singapore*. Press Release: December.
- Inland Revenue. 1997c. *Modernisation of Transfer Pricing Legislation*
- Inland Revenue. 1998a. *Modernisation of Transfer Pricing Legislation: Outcome of Consultations*.
- Inland Revenue. 1998b. *Modernisation of the Transfer Pricing Legislation: Outcome of Consultations*. Press Release: March.

- Inland Revenue. 1998c. *Transfer Pricing and Advance Pricing Arrangements*. Press Release: IR26. March.
- Inland Revenue. 1998d. *UK Proposal on EU Arbitration Convention Agreed*. Press Release: 84/98. May.
- Inland Revenue. 1998e. *Draft: Modernisation of the Transfer Pricing Legislation*. Draft Guidance on the Application of Section 12B TMA 1970 and Paragraph 21, Schedule 1F (No. 2)A 1998 for Transfer Pricing Purposes.
- Ioannou, L. 1995. Portugal's Enticements. *International Business*. October. pp82.
- Jacob, J. 1996. Taxes and Transfer Pricing: Income Shifting and the Volume of Intrafirm Transfers. *Journal of Accounting Research*. 34(2) Autumn. pp301-312.
- Johnstone, C. 1998. Move to Abolish Cross-Border Taxes. *European Voice*. February 23. www.eubusiness.com/finance/980223ev.htm (accessed at: 4 March 1998).
- Jonsson, S. 1998. Interview: Principal Consultant, KPMG Tax Adviser, KPMG, Birmingham.
- Khalaf, R. 1990. *America Bashing*. *Forbes*. November. pp171-175.
- Kim, K.Y. 1997. Transfer Pricing Taxation in Korea: Status Quo and Comments.
- Kim, S.H., Swinnerton, E. and Ulferts, G. 1997. 1994 Final Transfer Pricing Regulations of the United States. *Multinational Business Review*. Winter. pp17-18.
- King, E.A. 1994. *Transfer Pricing and Valuation Taxation: Federal Legislation Versus Administrative Practice*. Boston: Kluwer Academic Publishers.
- Kirsch, R.J. and Johnson, W. 1991. The Impact of Fluctuating Exchange Rates on US Multinational Corporate Budgeting for, and Performance Evaluation of, Foreign Subsidiaries. *The International Journal of Accounting*. 26:pp149-173.

- Knight, R.A. and Knight, L.G. 1997. New Competent Authority Procedures. *CPA Journal Online*. March. www.luca.com/cpajournal/1997/0397/features/f36.htm (accessed at: 27 February 1998).
- KPMG. 1997. *KPMG representations on the Consultative Document*.
- KPMG. 1998. EU Member States Not Obligated to Prevent Double Taxation. *Global Tax News*. June. No. 26.
- Kral, K., Serota, J. and Johnson, C. 1995. Complying with Global Transfer Pricing Rules. *Journal of Accountancy*. September. Vol. 180, issue 3. pp28-29.
- Laffie, L.S. 1995. Advance Pricing Agreement Program. *The Tax Adviser*. July. pp445.
- Layne, S. 1996. New Transfer Pricing Power Granted to French Tax Authority. *GT Online-Industries*. In Manufacturing and Distribution Issues, a Grant Thornton newsletter for industrial companies. Vol. 7, no. 4, Fall. www.gt.com/gtonline/mandist/issues/fall96g.html (accessed at: 18 December 1997).
- Lecraw, D.J. 1985. Some Evidence on Transfer Pricing by Multinational Corporations. In A.M. Rugman and L. Eden, eds., *Multinationals and Transfer Pricing*. pp223-240. New York: St Martin's Press.
- Leitch, R.A. and Barrett, K.S. 1992. Multinational Transfer Pricing: Objectives and Constraints. *Journal of Accounting Literature*. Vol. 11. pp47-92.
- Lester, E.E. 1999. *International Transfer Pricing Rules: Unconventional Wisdom*. www.nsulaw.nova.edu/pubs/journal/vol2_1/lesttext.htm#OECD (accessed at: 13 April 1999).
- Littlechild, M. and Gunde, L. 1997. Cashing in on the Euro. *Accountancy - International Edition*. June. pp55.

- Louw, E. 1998. South Africa: Transfer Pricing. *Global Tax Communique*. Spring. www.uk.coopers.com/coopers...ltaxcom/Spring 1998/Section15.html (accessed at: 22 June 1998).
- MacFarlanes and International Centre for Commercial Law. 1997a. *Transfer Pricing Legislation - New Consultative Document*. Corporate Tax Law. www.icclaw.com/devs/ukct_031.htm (accessed at: 27 March 1998).
- MacFarlanes and International Centre for Commercial Law. 1997b. *Transfer Pricing and the EU Arbitration Convention*. Corporate Tax Law. www.icclaw.com/devs/ukct_032.htm (accessed at: 27 March 1998).
- MacDonald, R. 1997. Taxing Times. *Business Mexico*. February. pp8-10.
- Mawani, A. 1997. *Canadian Tax Rules on Transfer Pricing*. Working Paper Faculty of Commerce and Business Administration, University of British Columbia.
- Mazero, M. 1994. Why Arm's Length Falls Short. *International Tax Review*. February. Vol.5, issue 2. pp28-32.
- Nurton, J. 1997. Facing Up to the Pharma Challenge. *Managing Intellectual Property Rights: Survey*. September. www.lawmoney.oyster.co.uk/publications/MIP/mip9709/mip9709.9.html (accessed at: 22 June 1998).
- OECD. 1994. Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. *Discussion Draft of Part I: Principles and Methods*. Report of the OECD Committee on Fiscal Affairs, Paris.
- OECD. 1995a. Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. *Discussion Draft of Part II*. Report of the OECD Committee on Fiscal Affairs, Paris.

- OECD. 1995b. *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. Report of the OECD Committee on Fiscal Affairs, Paris.
- OECD. 1996. OECD Council. Recommendations on Taxation. July. www.oecd.org/search97cgi/s...minImagePath=%2Fsearch97.march.htm (accessed 15 June 1998).
- OECD. 1997. Tax and Multinationals - Transfer Pricing. *OECD-Fiscal Affairs-Finance, Investment, Taxation and Competition*. www.oecd.org/daf/fa/wp6.htm (accessed at: 18 December 1997).
- OECD. 1998a. 1998 Transfer Pricing Guidelines Update. *OECD Taxation and Fiscal Affairs*. March. www.oecd.org/daf/fa/MATERIAL/c_1998TP.HTM (accessed at 15 June 1998).
- OECD. 1998b. *Model Tax Convention. Recommendations on Taxation*. www.oecd.org/daf/fa/TREATIES/treaty.htm (accessed at: 25 August 1998).
- Ogum, G. and Kim, K.A. 1995. New U.S. International Transfer Pricing Regulations. *Multinational Business Review*. Spring. pp8-13.
- Otsuka, I. 1994. Japan and U.S. in Transfer Price War. *International Tax Review*. July/August. Vol.5, issue 7. pp9-10.
- Outram, R. 1996. The Great Escape. *Management Today*. September. pp56-58.
- Pass, C. 1994. Transfer Pricing in Multinational Companies. *Management Accounting*. (UK) 72(8) September, pp44-50.
- Patton, M.F. 1989. The Section 482 White Paper Seen Through a Contact Lens: An Analysis of Bausch and Lomb v. Commissioner. *Tax Management International Journal*. September. pp451-464.
- Patton, M.F. 1998. Canada and UK Propose Arm's Length Transfer Pricing Rules. *The Tax Adviser*. January. Vol.29, issue 1. pp13-14.

- Patton, M.F. and Wood, K.W. 1995. The APA Program Lifecycle Moves from Start Up to Growth Stage: Proposed Update of Rev Proc. 91-22. *Tax Management International Journal*. Articles. pp363-370.
- Peterson, S. 1994. Towards Greater Cooperation. *International Tax Review*. Supplement. July/August. pp2-4.
- Picciotto, S. 1992. International Taxation and Intrafirm Pricing in Transnational Corporate Groups. *Accounting Organisations and Society*. Vol. 17, no. 8. pp759-792.
- Plambeck, C. 1994. APA Programme Accelerates. *International Tax Review*. September. pp44-47.
- Plasschaert, S.R.F. 1979. *Transfer Pricing and Multinational Corporations*. In association with European Centre for Study and Information on Multinational Corporations. Saxon House.
- Plasschaert, S.R.F. 1985. Transfer Pricing Problems in Developing Countries. In A.M. Rugman and L.Eden, eds., *Multinationals and Tansfer Pricing*, 247-66. New York: St Martin's Press.
- Plasschaert, S.R.F. 1994. The Multiple Motivations for Transfer Pricing Modulations in Multinational Enterprises and overnmental Counter-Measures: An Attempt at Clarification. *Management International Review*. Special Issue, vol 34, pp36-50.
- Pointon, J. 1994. *Issues in Business Taxation*. Avebury Publishing Ltd, Aldershot.
- Price Waterhouse. 1997. Transfer Pricing Draft Rules - Revenue Canada Gets its Needed Teeth. *Price Waterhouse Tax Services*. September.
- Reed, S. Holyoke, L and Harbrecht, D. 1994. Here Comes the Great Global Tax War. *Business Week*.. May, issue 3374. pp55-56.

- Rehder, J. 1996. *Transfer Pricing and the Use of Advance Pricing Agreements in Germany and the U.S.* Faegre and Benson Professional Limited Liability Partnership. January. www.faegre.com/areas/area_ib2.html (accessed at: 18 December 1998).
- Richards, R. 1993. Transfer Pricing - Myth Versus Reality. *Australian Accountant*. December. Vol. 63, issue 11. pp59-62.
- Riley, P. and Diamond, G. 1997. Australia: Transfer Pricing Ruling. *International Tax Review*. December. www.lawmoney.com/public/co...ons/ITR97/itr9712/itr9712.8b.html (accessed at: 6 February 1998).
- Rolfe, C. 1998. Interview: International Tax Partner, Coopers and Lybrand, London.
- Rooney, P.C. and Fortunato, D.R. 1994. US Moves to a More Flexible Approach. *International Tax Review*. pp40-48.
- Ross, H.J. 1996. List of UK Double Tax Treaties on Income and Capital. *The UK Tax World of Harry J Ross FTII FCA*. August. www.users.dircon.co.uk/~ross/dtas.htm (accessed at: 18 December 1997).
- Ryan, E. D. and Patton, M. F. 1991. IRS Advance Pricing Agreements: Are They a Practical Means to Resolve Potential International Transfer Pricing Disputes? *Tax Management International Journal*. Articles. pp115-123.
- Sayer, R. 1995. Compliance Over-Burdens Companies. *International Tax Review*. February. Vol 6, issue 2. pp19-21.
- Schwartz, M., Zimmerman, P., Peterson, J. and Seickel, S. 1995. Steps Towards International Consensus. *International Tax Review*. December 1994/January 1995. Vol 6, issue 1. pp31-35.
- Self, H. 1995. OECD Transfer Pricing Guidelines: Part II. *British Tax Review*. No. 4, pp358-362.

- Sherwood, S.G. 1997. Penalties Impose New Policies. *International Tax Review*. July/August. Vol. 8, No. 7.
- Sherwood, S.G., Huang, M. and Shum, E. 1997. "Turnover of Hong Kong to China: International Tax Issues Confronting US and Other Multinationals After July, 1997". *Tax Management International Journal*. May.
- Simon. 1997. *Simon's Tax Cases*. Chapter/Section 36 Double Taxation Relief. pp1693-1750.
- Skantz, T.R. 1995. New Transfer Pricing Documentation Requirements and Penalties. *CPA Journal*. Luca.com. April. www.luca.com/cpajournal/old/17015440.htm (accessed at: 18 December 1998).
- Stitt, I. 1995. Transfer Pricing for the Next Century. *Accountancy*. November. pp92-94.
- Swiss, S. 1995. Trust is the Key to Transfer Pricing. *International Tax Review*. May. Vol 6, issue 5. pp12-14.
- Tadaki, J.M. 1993. Japanese Subsidiaries in US Worried by Clinton Tax Shift. *The Japan Times Weekly International Edition*. March 29-April 4. p14.
- Tang, R.Y.W. 1993. *Transfer Pricing Strategies in the 1990's*. Quorum Books.
- Triplett, C. 1994. U.S. Leads in Advance Pricing Agreements. *International Tax Review*. February Supplement. pp330-39.
- Tugendhat, C. 1971. *The Multinationals*. Eyre and Spottiswoode Ltd, London.
- UK Government. 1988. Income and Corporation Taxes Act.
- US Government - IRS. 1996. Rev. Proc. 96-53, 1996-49 I.R.B. 9 (*Advance Pricing Agreement Procedure*).

- Wagner, D. 1998. *International Taxation, Tax Havens, and Transfer Pricing*. www.pacific.commerce.ubc.ca/keith/Lecture/tax.htm (accessed at 5 August 1998).
- Wagstyl, S. 1997. Revenue Sets Sights on Overseas Income: Proposals Seek to Stop Multinationals Using Export Transactions to Cut Tax Bills. *Financial Times*. 13 October. p10.
- Ward, D.A. and Armstrong, N. 1994. Eliminating Transfer Pricing Uncertainties in Canada. *International Tax Review*. February. Transfer Pricing Supplement. pp3-8.
- Wartzman, R. 1992. Foreign Firms Uneasy Over Tax Proposals. *The Asian Wall Street Journal*. July 20. p2.
- Wartzman, R. 1993. IRS Sets Pricing Rules for Multinationals. *The Asian Wall Street Journal*. January 15. p2
- Will, G. 1998. Transfer Pricing - A Higher Standard of Compliance. *CMA Magazine*. December/January. pp36.
- Wolf, J. 1997. Brazil: New Transfer Pricing Regulations. *Global Tax Communique*. Coopers and Lybrand. August. www.uk.coopers.com/tax/pag...axcom/summer1997/globalpage3.html (accessed at: 26 February 1998).
- Wrappe, S.C. 1997. Working with the New IRS Procedures: A Silver Lining in the Transfer Pricing Cloud. *Tax Management International Journal*. Articles. pp27-32.
- Wright, D.R., Nelson, C. K. and Kasdan, J.C. 1995. TNMM - The OECD's Response to CPM: Are They Really Different? *European Taxation*. Vol. 35, issue 10. p306-314.
- Yoost, D.A. and Miyajima, D. 1997. Japan Pursues Foreign Multinationals. *International Tax Review*. September. www.lawmoney.com/public/co...ions/ITR9709/itr9709.2.html (accessed at: 6 February 1998).

Zach, C. 1993. What Do Multinationals Think of Global Tax Issues? *International Tax Review*. October. pp13-16.